S. HRG. 109–114

# CONCURRENT RESOLUTION ON THE BUDGET FOR FISCAL YEAR 2006

# HEARINGS

BEFORE THE

# COMMITTEE ON THE BUDGET
# UNITED STATES SENATE

ONE HUNDRED NINETH CONGRESS

FIRST SESSION

**February 1, 2005—THE CBO BUDGET AND ECONOMIC OUTLOOK**

**February 8, 2005—REEXAMINING THE FEDERAL BUDGET FOR THE 21ST CENTURY**

**February 9, 10, 2005—THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL**

**February 16, 2005—TRANSPARENCY OF BUDGET MEASURES**

**February 17, 2005—MEDICARE AND MEDICAID: RISING HEALTH CARE COSTS AND THE IMPACT ON FUTURE GENERATIONS**

**March 1, 2005—THE PRESIDENT'S FISCAL YEAR 2006 DEFENSE BUDGET**

Printed for the use of the Committee on the Budget

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# THE CBO BUDGET AND ECONOMIC OUTLOOK

**TUESDAY, FEBRUARY 1, 2005**

U.S. SENATE,
COMMITTEE ON THE BUDGET,
*Washington, DC.*

The committee met, pursuant to notice, at 9:55 a.m., in room SD–608 Dirksen Senate Office Building, Hon. Judd Gregg presiding.

Present: Senators Gregg, Domenici, Allard, Enzi, Bunning, Crapo, Alexander, Graham, Conrad, Sarbanes, Murray, Johnson, Byrd, Nelson, Stabenow, and Corzine.

Staff present: Scott B. Gudes, Majority Staff Director; and Dan Brandt.

Mary Ann Naylor, Staff Director; Sue Nelson and Jim Esquea.

## OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We are fortunate enough to have the director of CBO here, and Senator Conrad has been kind enough to be here early, which is, I expect, a North Dakota habit anyway, and so, now that we have everybody here, we can get started, even though it is a little early, and as other members arrive, we will be happy to have them participate.

The purpose of this hearing is to hear from the director on the baseline. This is a traditional hearing of the Budget Committee and an important one. It is my first hearing as chairman, and I want to begin by thanking the staff of both Republican and the Democratic side for being so courteous to me and in my assuming this position, being so helpful.

I want to thank Senator Conrad for his very kind and generous courtesy as we have sort of settled into this new role. We have served together a long time a time and have great respect for each other, and I especially want to express consideration and appreciation for all the work that Senator Nickles did as my predecessor. He was an excellent chairman and set a very high standard of fairness and objectivity and transparency, which I hope to carry on, obviously.

This is an important committee for a lot of various reasons, but I consider it important because it sets the memo that controls the meeting; essentially, the budget drives the process around here, and we have an obligation to put out a budget that will effectively drive that process. The purpose of this memo over the coming year, I hope, will be to take control of the fiscal house of the Federal Government, move us back toward a position of balancing our budgets, reaching a goal of reducing the deficit in half in 4 years,

that is my goal, and having effective enforcement mechanisms so that Members of Congress who feel they want to assert their rights to exercise fiscal discipline will have tools to do that, and it is my goal to produce such a budget, and hopefully, we can do that in a way that is, if not necessarily totally bipartisan, at least perceived as fair and honest in its approach.

We obviously will hear from the President as to his budget at the beginning of next week, I believe, and that will set the tone as we move forward. But the initial step is to figure out where we are today, and that goes to the baseline. These are the figures off which we function. We need to have a fair number that everybody agrees on is what we are working off of. There are obviously some issues with any baseline, but it is critical that we do have a baseline, because otherwise, we are never going to be able to figure out what we are talking about relative to each other.

So this is a critical issue for us, what the baseline is, and we very much appreciate the Director's coming by today to give us his thoughts and to set such a baseline for us, and at this time, I would yield to Senator Conrad.

**OPENING STATEMENT OF RANKING MEMBER KENT CONRAD**

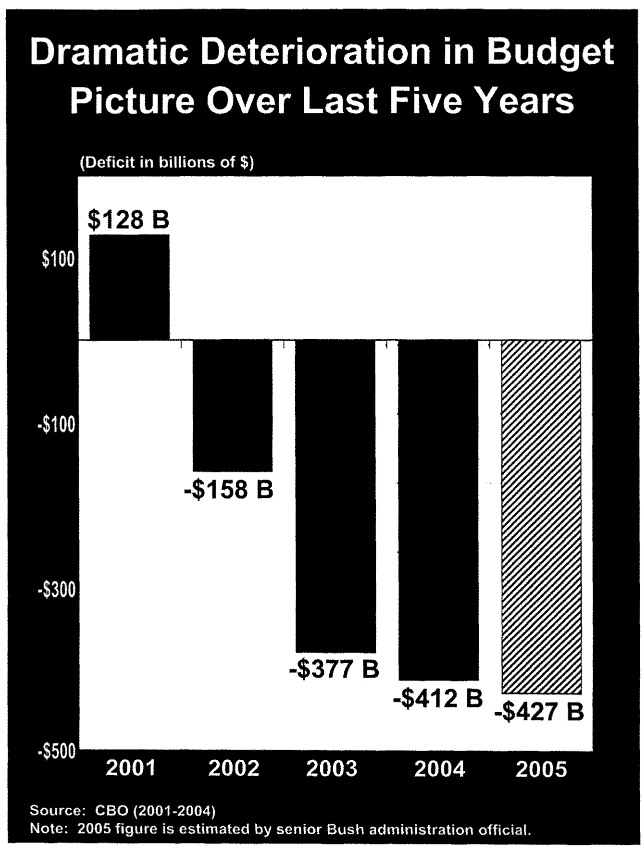
Senator CONRAD. Thank you, Mr. Chairman.

Thank you first of all for the many courtesies that you have extended to our side of the aisle during the transition. We appreciate very much the way you and your staff have accommodated us as these changes were made. It is certainly a very good start to a relationship, and I want to thank the Chairman. I also want to welcome him to his new responsibility and to indicate that I very much look forward to working with him.

We have a long relationship, having served for many years together in the Senate. We have areas where we very much agree. I think both of us believe that deficits do matter and that these budget deficits that we have now are too large, and they need to be reduced, and that we have a role with our colleagues, a responsibility in trying to put forward plans to get these deficits under control.

I want to thank Mr. Holtz-Eakin for his appearance today and for the hard work of his organization. They help us judge where we are and where we are headed.

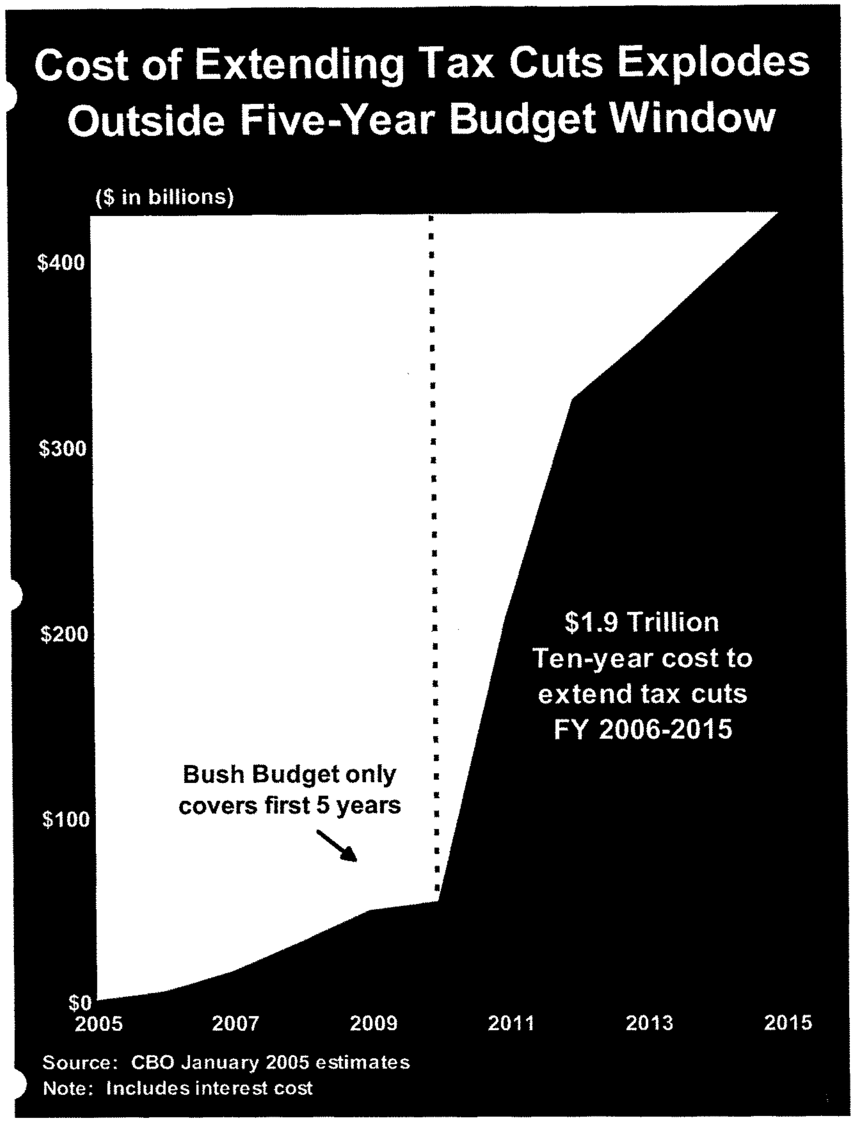
If I could, I would like to start off with just a few charts with respect to our current condition and look ahead to what we see coming if we do not take action. This first chart shows what has happened over the last several years. Back in 2001, we had a budget surplus of $128 billion. Every year since then, the deficit has grown larger: record deficits of $377 billion in 2003; $412 billion last year; and now, the administration is projecting a deficit this year of $427 billion, a new record.



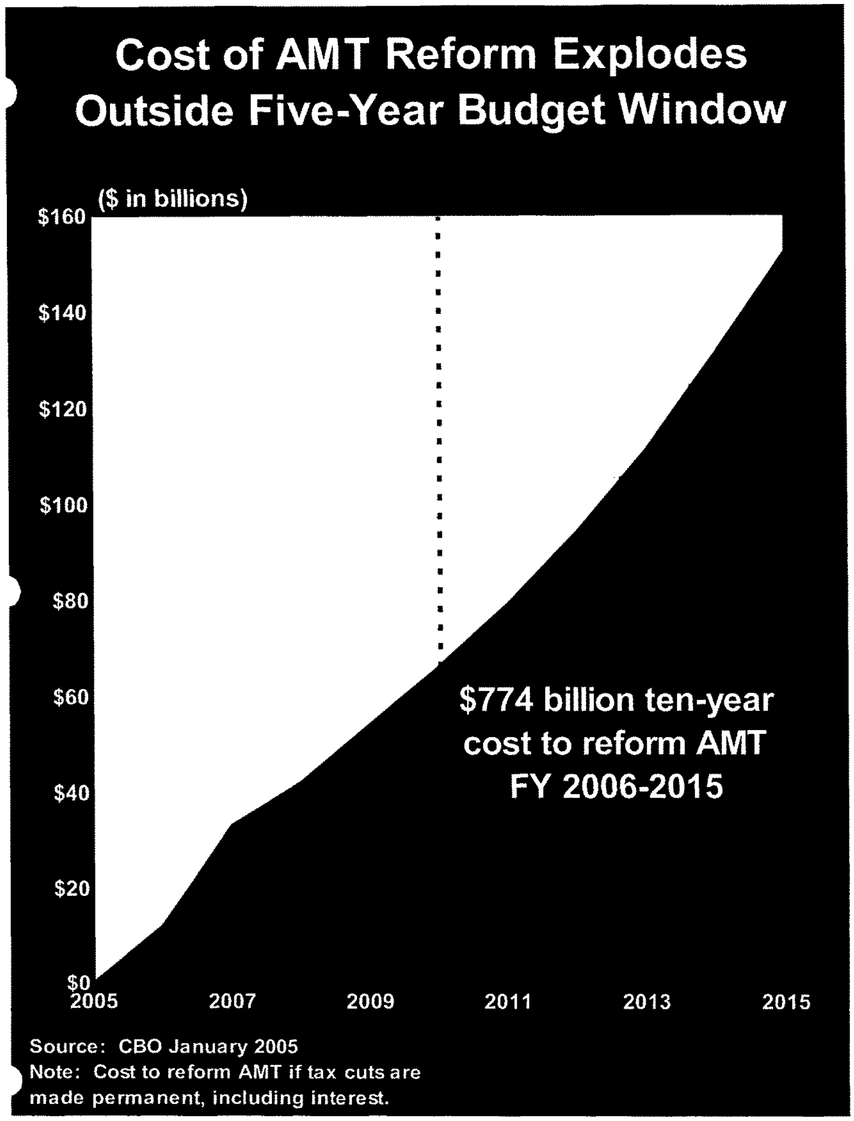

The great concern that I have is not just the next 4 years or 5 years. The President has set a goal of reducing the deficit, cutting it in half in the next 5 years. My great concern is what happens outside the budget window. The President has proposed making the tax cuts permanent. This dotted line shows the effect for the next 5 years of the budget window. But look at what happens after the 5-years of the budget window to the cost of the proposed tax cuts: they absolutely explode beyond the 5-year budget window.

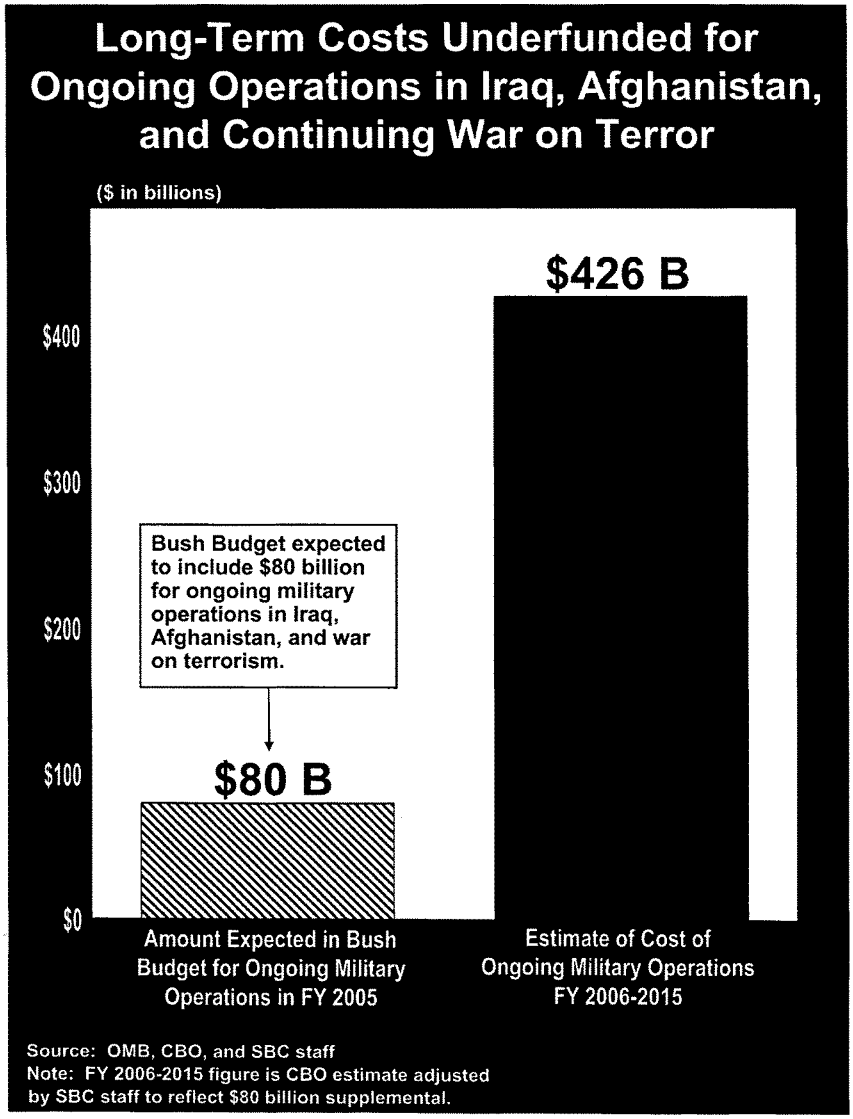
Let us go to the next chart. That is not only true of the tax cuts proposed by the President. That same pattern pertains to fixing the alternative minimum tax, the old millionaires' tax that is now becoming a middle class tax trap; 3 million people affected now. Ten years from now, there will be 40 million people caught up in the

alternative minimum tax if we fail to take action; the cost, over $770 billion to address that. That is not in any of the budget numbers; that is not in the CBO report today. I am not faulting CBO. It is not their fault that it is not there. It is the rules that they *COM007*are governed by.


Cost of Extending Tax Cuts Explodes Outside Five-Year Budget Window
($ in billions)
$400
$300
$200
$100
$0
2005
2007
2009
2011
2013
2015
Bush Budget only covers first 5 years
$1.9 Trillion
Ten-year cost to extend tax cuts
FY 2006-2015
Source: CBO January 2005 estimates
Note: Includes interest cost

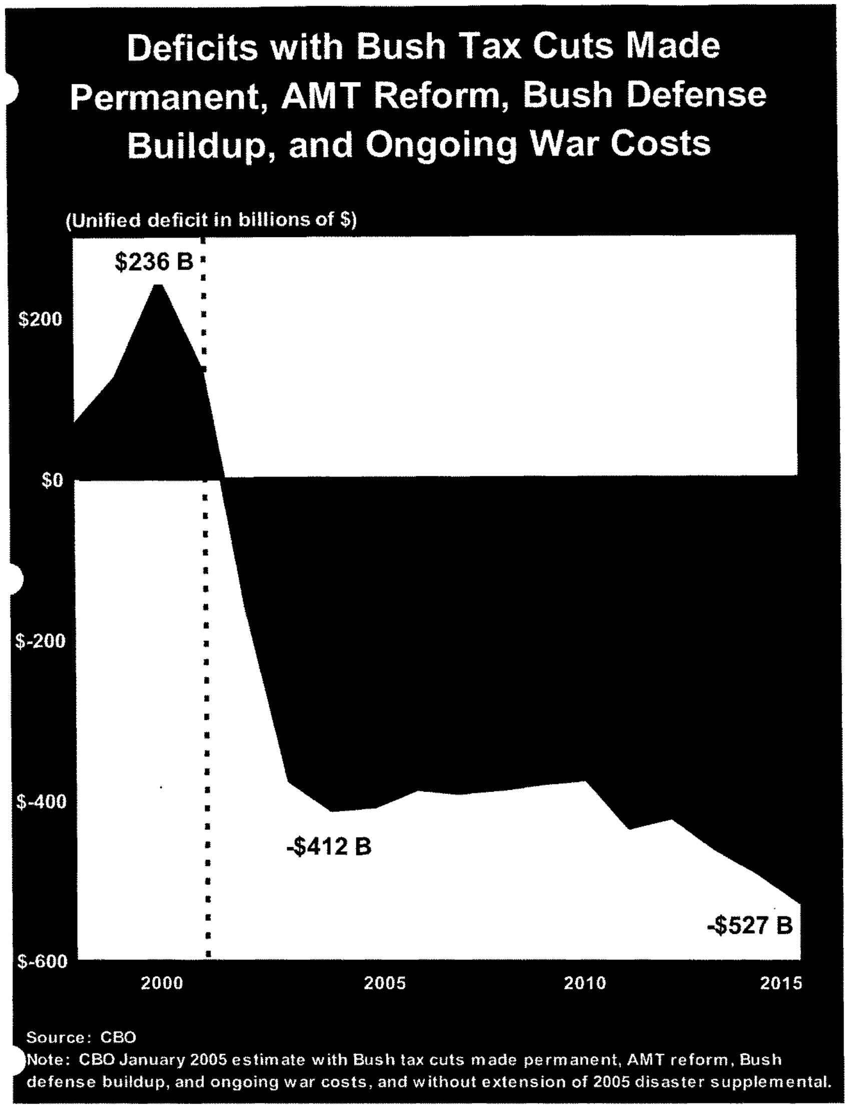
Let us go to the next chart. I think maybe we should make clear that CBO is required to do their estimates based on current law, and so, when the President proposes additional tax cuts, they are not in the CBO estimate. When we have a challenge of the alternative minimum tax, that is not in their estimates. We see the same pattern with respect to the cost of the war. There is the $80 billion that the President has just requested, but the long-term outlook over the next 10 years is $426 billion of additional spending for residual war costs.


Cost of AMT Reform Explodes
Outside Five-Year Budget Window
($ in billions)
$160
$140
$120
$100
$80
$60
$40
$20
$0
2005
2007
2009
2011
2013
2015
$774 billion ten-year
cost to reform AMT
FY 2006-2015
Source: CBO January 2005
Note: Cost to reform AMT if tax cuts are
made permanent, including interest.

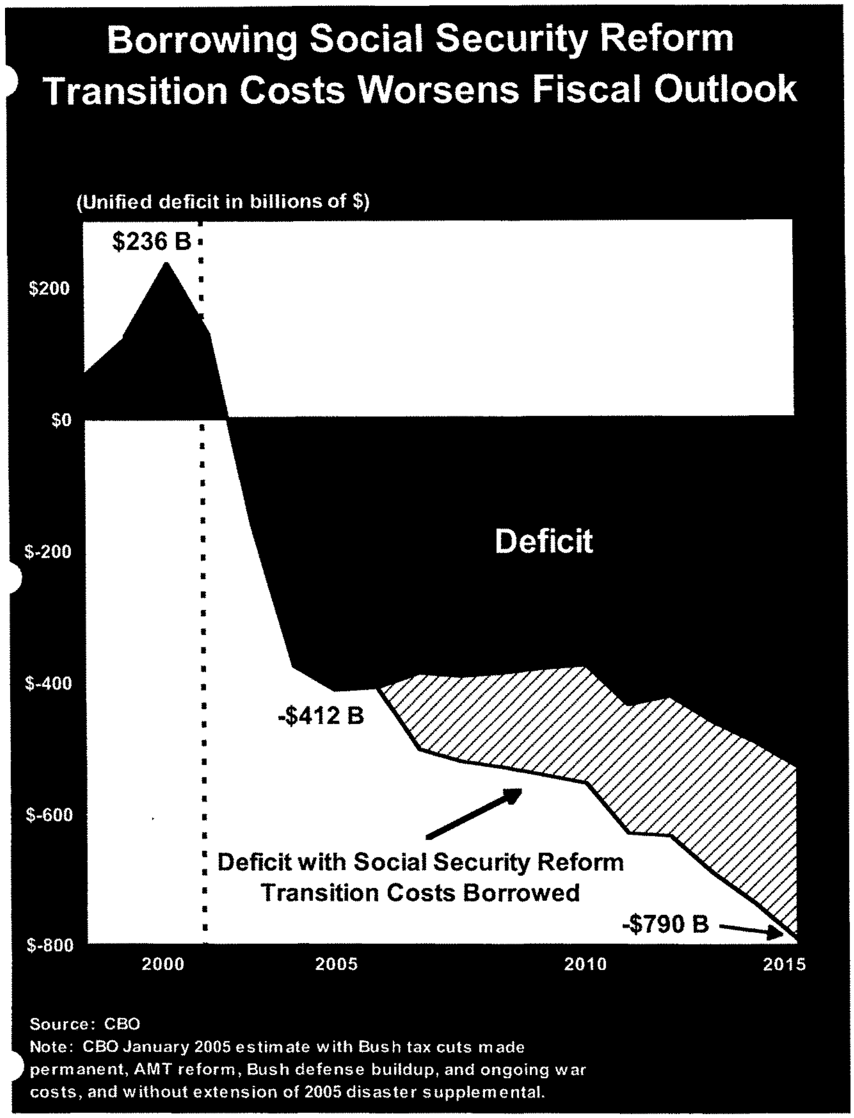

Long-Term Costs Underfunded for Ongoing Operations in Iraq, Afghanistan, and Continuing War on Terror
($ in billions)
$400
$300
$200
$100
$0
$426 B
Bush Budget expected to include $80 billion for ongoing military operations in Iraq, Afghanistan, and war on terrorism.
$80 B
Amount Expected in Bush Budget for Ongoing Military Operations in FY 2005
Estimate of Cost of Ongoing Military Operations FY 2006-2015
Source: OMB, CBO, and SBC staff
Note: FY 2006-2015 figure is CBO estimate adjusted by SBC staff to reflect $80 billion supplemental.

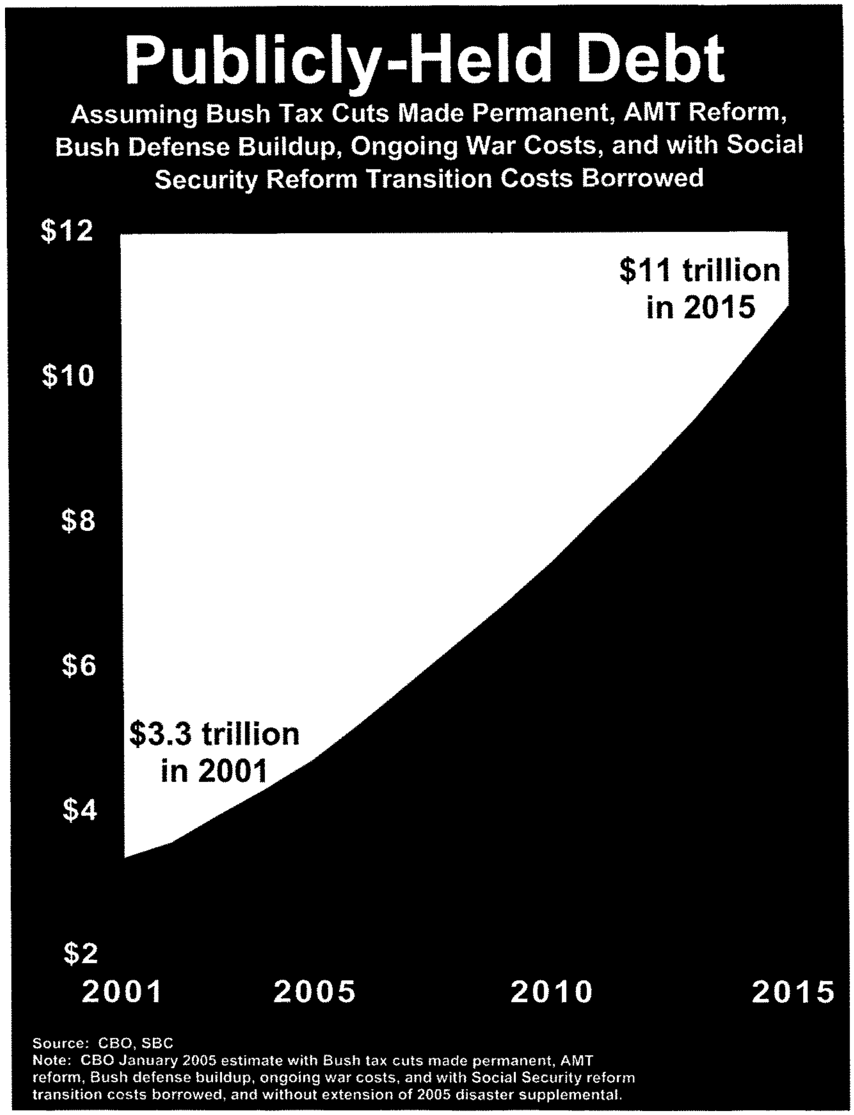
When put all those things back in, what we see over the next 10 years is red ink as far as the eye can see. We see massive deficits not only this year but every year going forward over the next 10 years with very little improvement during this period.

Let us go to the next chart. If, as some are proposing, we fund the transition cost of changing Social Security, moving some part of Social Security into private accounts, that would make the deficit situation even more dire. We would go from an ocean of red ink to an expanding ocean of red ink so that by the end of the 10-year period, we would be approaching a shortfall of $800 billion a year.


Deficits with Bush Tax Cuts Made Permanent, AMT Reform, Bush Defense Buildup, and Ongoing War Costs
(Unified deficit in billions of $)
$236 B
$200
$0
$-200
$-400
-$412 B
-$527 B
$-600
2000
2005
2010
2015
Source: CBO
Note: CBO January 2005 estimate with Bush tax cuts made permanent, AMT reform, Bush defense buildup, and ongoing war costs, and without extension of 2005 disaster supplemental.

Let us go to the next chart. If we put all those things back in the calculation that CBO does not include because they are not allowed to under the rules that govern them, we see that the publicly held debt of the United States explodes to $11 trillion by 2015. And this money is being borrowed not only from ourselves, but from around the world. We have now borrowed over $700 billion from Japan; over $190 billion from China. We have even borrowed more than $69 billion from South Korea. Some of us are alarmed by this dramatic increase in our external debt. Our external debt has increased 82 percent in just the last 3 years.


Borrowing Social Security Reform Transition Costs Worsens Fiscal Outlook
(Unified deficit in billions of $)
$236 B
$200
$0
$-200
$-400
$-600
$-800
Deficit
-$412 B
Deficit with Social Security Reform Transition Costs Borrowed
-$790 B
2000
2005
2010
2015
Source: CBO
Note: CBO January 2005 estimate with Bush tax cuts made permanent, AMT reform, Bush defense buildup, and ongoing war costs, and without extension of 2005 disaster supplemental.


Publicly-Held Debt
Assuming Bush Tax Cuts Made Permanent, AMT Reform, Bush Defense Buildup, Ongoing War Costs, and with Social Security Reform Transition Costs Borrowed
$12
$10
$8
$6
$4
$2
$11 trillion in 2015
$3.3 trillion in 2001
2001
2005
2010
2015
Source: CBO, SBC
Note: CBO January 2005 estimate with Bush tax cuts made permanent, AMT reform, Bush defense buildup, ongoing war costs, and with Social Security reform transition costs borrowed, and without extension of 2005 disaster supplemental.

Let us go to the final chart. This is why it matters: the Financial Times ran this headline last week: Central Banks Shun U.S. Assets. And the point that they are making in this article is that increasingly, foreign banks are concerned about the debt of the United States, both the trade deficit and the budget deficit and the extraordinary borrowing that are required by both.

## Top Ten Countries Holding Our National Debt

| | |
|---|---|
| Japan | $715 B |
| China | $191 B |
| United Kingdom | $152 B |
| "Caribbean Banking Centers" | $76 B |
| South Korea | $69 B |
| OPEC | $61 B |
| Taiwan | $58 B |
| Germany | $56 B |
| Switzerland | $51 B |
| Hong Kong | $50 B |

Source: Department of Treasury
Note: As of November 2004

FINANCIAL TIMES

# Central banks shun US assets

**Shifting reserves to eurozone will deepen Bush's difficulties in funding deficit ● Actions likely to undermine dollar's value further**

By Chris Giles, Economics Editor

Central banks are shifting reserves away from US assets and towards the eurozone in a move that looks set to deepen the Bush administration's difficulties in financing its ballooning current account deficit.

In actions likely to undermine the dollar's value on currency markets, 70 per cent of central bank reserve managers said they had increased their exposure to the euro over the past two years. The majority thought eurozone money and debt markets were as attractive a destination for investment as the US.

The findings emerge from a survey of central bank reserve managers published today and conducted between September and December of last year. About 65 central banks, controlling assets worth $1,700bn, took part and the results showed a marked change in attitude over the past two years.

Any rebalancing of central bank reserve portfolios has serious implications for the global financial system as the US has become increasingly dependent on official flows of funds to finance its current account deficit, estimated at $650bn in 2004.

At the end of 2003, central banks held 70 per cent of their official reserves in dollar-denominated assets and central bank purchases of US securities had financed more than 80 per cent of the the US current account deficit in 2003.

Any reluctance to increase exposure to dollar assets further could cause the greenback to plunge on currency markets.

"The US cannot take support for the dollar for granted," said Nick Carver, one of the authors of the study conducted by Central Banking Publications, a company that specialises in reporting on central banks.

"Central banks' enthusiasm for the dollar seems to be cooling off."

In a further worrying sign for the greenback, 47 per cent of reserve managers surveyed said they expected the growth of official reserves to slow to less than 20 per cent over the next four years. Between the end of 2000 and mid-2004, official reserves had increased by 66 per cent.

Slower reserve accumulation growth implies the supply of official finance is likely to become more limited but few expect the demand from the US for finance to slow. The consensus among economists is that the US current account deficit will increase to $800bn in 2005.

More than 90 per cent of central bank reserve managers said that the income from reserve management was "important" or "very important".

In the two years since a similar survey was conducted, reserve managers had begun to seek higher returns for the money under management.

For these managers, dollar assets have become less attractive because the fall in the dollar since 2002 has reduced the yield they received and, in some cases, has led to negative real returns.

Alan Greenspan, the chairman of the Federal Reserve, warned in November that there was a limit to the willingness of foreign governments to finance the US current account deficit.

The survey was conducted on the guarantee of anonymity for the banks involved. The 65 central banks that participated control 45 per cent of global official reserves. Individually, they had up to $150bn under management.

The People's Bank of China and the Bank of Japan control larger official reserves than this so it is clear that they did not respond to the survey.

US depends on central banks, Page 2
Week Ahead, Page 24
News background: www.ft.com/dollar

That sums up the additional comments I wanted to make, Mr. Chairman, as we head into a review by Mr. Holtz-Eakin of their long-term outlook. I thank you.

Chairman GREGG. Thank you, Senator.

Chairman GREGG. And as the tradition with this Committee, the Chairman and the Ranking Member make an opening statement, and then, we turn to our witness. So, Director, we would love to hear your thoughts on where we are going with the baseline.

## STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Well, Mr. Chairman, Senator Conrad, thank you for the chance to appear today. You have our written testimony and our larger report, which I think is a tribute to the CBO staff and I hope a service to the Congress. I thought I would spend a few minutes hitting some of the main points and then would be happy to answer your questions.

As you know, the Federal budget ran a deficit of $412 billion in fiscal year 2004. Under the baseline projections, the deficit in 2005 will be $368 billion, including a reasonable allowance for the costs of operations in Iraq and Afghanistan, the fiscal year 2005 deficit is likely to be about $400 billion. This is a modest improvement. It is an improvement both in absolute terms and as a share of our national income, down from 3.6 percent of GDP to 3.3 percent.

Nevertheless, the likely path in the future depends heavily on policies chosen by Congress and the administration. Clearly, the baseline, because of the conventions involved, does not include the cost of ongoing operations in Iraq and Afghanistan or other appropriations as necessary in the global war on terrorism, and that will likely cause spending to be higher.

The baseline includes a tax policy that has taxes rising in 2009, with the expiration of rates on capital gains and dividends, and sharp rises in 2011 with the expiration of the EGTRRA and JGTRRA tax provisions. We have heard much talk of taxes not going up, instead staying at their current levels or even being reformed, and the baseline importantly includes a path of mandatory spending that will not only accelerate during the course of the 10-year budget horizon but increasingly become larger thereafter.

So it is important, I think, to look at changes in the recent budget situation since last summer, where they are modestly worse when done on an apples-to-apples comparison, and then, to think about the path going forward as largely dictated by policy choices of the Congress and the administration.

We are building on a firm foundation. The U.S. economy is in the midst of a solid, private-sector led economic recovery, moving back toward its potential. It has experienced solid, long-term productivity growth, which is a great hope for the future, and as a result, it is best to think of the economy as not contributing to the budget deficit, that is a minor contribution, but rather, the policies chosen being built upon a stronger economy that will allow us to address these issues. Nevertheless, I think even given very strong growth, it is a bad bet to think that we will simply grow out of the current budget situation.

And finally, in thinking about policy choices, I will close at the end by emphasizing again that mandatory spending represents the largest share of the Federal budget and the most rapid source of growth.

So let me walk through those points in a little more detail and then take your questions. The graph indicates the CBO baseline budget projection. It is, as Senator Conrad noted at the outset, a current law projection. It represents the path of the Federal budget on essentially fiscal autopilot. If we were to simply track all discretionary spending that was on the books at the close of 2005 and raise it at the rate of inflation, if we were to allow all mandatory spending programs to execute as they are currently written in law, and if the tax code proceeds as currently written in law, we will see steadily diminishing budget deficits over the next several years, down from $368 billion or 3 percent of GDP; by 2010, it will be $189 billion, 1.2 percent of GDP, and thereafter, a return toward surplus and a total over the 10 years of $855 billion or half a percent of our GDP in budget deficits.

Now, this baseline has changed somewhat since last September, and those changes are a bit hard to discern, largely because of two important differences. The first and the largest is that in September, when we did our baseline projections, there were $115 billion in appropriations on the books, mostly for operations in Iraq and Afghanistan. Baseline conventions say include $115 billions on the books every year; assume policy is unchanged, and raise it at the rate of inflation. Doing so, 10 years of $115 billion, inflation, debt service, contributes to $1.4 trillion of 10-year spending from those appropriations alone.

At the moment, we have no supplemental appropriations for Iraq and Afghanistan, so we follow the same conventions. We put zero in for 10 years, raise it at the rate of inflation; we get zero. It is an apparently large swing in the fiscal outlook, but it has to do with the baseline conventions and nothing real.

This chart shows that if you put it on an apples-to-apples basis, indeed, the 10-year budget outlook has worsened modestly. About three-quarters of that is legislation and a quarter economic and technical revisions.

We turn next to the economy and the likely outlook. The most important feature of the CBO forecast is the outlook for productivity growth. It certainly, as everyone knows, figures into the long-term standards of living in the United States. Accordingly, it figures heavily into the long-term capacity to fund both private-sector needs and wants as well as the Government budget. A one-tenth of a percentage point increase in a sustained way in the level of productivity contributes about $250 billion to 10-year budget deficit reduction. So swings in productivity are very important over the long-term.

Over the near term, the assessment of productivity is simultaneously an assessment of the capacity of the economy to absorb this cyclical recovery without generating capacity constraints and inflationary pressures. At the moment, assessing future productivity is particularly difficult. As is widely known, post-1995, the United States has experienced an acceleration in productivity that has been a great boon to our economic fortunes.

Most surprisingly, during the most recent recession and recovery, in contrast to the typical pattern of slower productivity growth and then a pickup as the economy comes out, we have seen an even more sharp increase in productivity in the United States. This leaves us with the difficult question of assessing whether to take the extrapolation of that sharp increase or to remain with a projection that looks like the post-1995 experience of the United States.

Given the propensity for productivity to be revised and the value as a result of being patient before we certify something as permanent, we have adopted a middle course, where we assume that there is a greater level of productivity, a greater capacity for production and income in the U.S., but we are going to assume the post-1995 growth rate for productivity. It is an important issue that is probably the most important wild card in our outlook and one we are constantly reviewing.

Other risks to the outlook that are worth just mentioning are, in no particular order, first, oil prices. Oil prices remain difficult to gauge in the current international environment. They are a bit higher at present than they were when we put the forecast to bed, about $4 a barrel likely in 2005, $2 a barrel in 2006; those will have small impacts on economic performance. $10 a barrel of oil is worth about two-tenths of a percent in GDP growth. Nevertheless, it is something we will watch closely.

And more generally, it is the case that a wide variety of economic uncertainties exist. The most prominent is the economic consequences of a terrorist act, followed by concerns on international trade and international finance, the pace of world economic recovery, the potential for housing prices to moderate their growth somewhat in the United States or households to save more. All of those figure into the kinds of uncertainties that we have experienced in the past and are likely to revisit again in the future in mapping the course of the economy into the budget outlook.

Let me turn now to the spending and the receipt side of the budget. Most of the attention recently has focused on discretionary spending, and it has been particularly difficult to judge the pace of spending growth, given the path of supplemental appropriations. This chart summarizes some of what we know. If we exclude supplemental defense spending between 2004 and 2005, appropriations for that area rose by 6.7 percent; in the non-defense, non-homeland section, 2.6 percent; homeland security appropriations rose by over 14 percent, with the net result that overall, appropriations grew 5.1 percent between 1904 and 1905, exclusive of all supplementals.

Going forward, the baseline outlook that you saw assumes that outlays for discretionary spending will grow at a much slower rate. They will grow only at the rate of inflation, and as a result, there is a mismatch between the most recent experience and the projections that we have put before you in the baseline.

However, the real dollars in the Federal budget are on the mandatory side. Mandatory programs now constitute over half of Federal spending; the three that are most notable in their size and growth are Social Security, currently the single largest Government program, $500 billion, which is growing at present about 4.5 percent per year but which will by the end of the budget window be growing at over 6 percent per year.

Medicare and Medicaid, currently behind Social Security, will overtake the outlays for Social Security during the 10-year budget window. They will grow at 9 percent from Medicare, a bit under 8 percent for Medicaid, and the net result will be that those three programs will constitute over one-half of Federal spending by 2015 in the baseline.

This rapid growth in Federal spending is on the other side of the ledger confronted with fairly rapid growth in Federal receipts, on average, about 6.5 percent. Most of that is in the rapid growth of individual income tax receipts. The good news is that we have seen that receipts have begun to rise again this year as opposed to the past several years when they fell. We anticipate that individual income tax rates will rise about 8.5 percent per year over the 10 years, with the result that total Federal receipts will climb from about 16.8 percent of our national income, nearly 17 cents on the national dollar, below the historic average of 18 percent in the post war, to about 19.6 percent of our national income by 2015.

That rise in the Federal effective tax rate comes in two pieces. One piece is legislation, where about 1.5 percent of that rise is due to the sunset of tax provisions. The remainder is due to real economic growth and higher personal incomes and a bit from the cashout of IRAs and 401(k)'s as the baby boom moves toward retirement and finally, a bit more from the alternative minimum tax that Senator Conrad mentioned at the outset.

Given the importance of policies for the ultimate fiscal outlook going forward, we included in our reports some illustrative alternatives on the discretionary side and on the tax side. I leave those for you to read and simply note in closing that we did not include any illustrative scenarios for mandatory programs. They obviously presented themselves as central to the policy debate, but it is the case that over the longer term, the combined spending on Medicare and Medicaid and Social Security will place increasingly large demands on the Federal budget, and that left at historic rates, the growth in these health programs especially will likely outstrip our ability to finance them and place our fiscal policy on an unsustainable course.

With that cheery close, I thank you for the chance to be here today and look forward to answering your questions.

Chairman GREGG. Do you know Senator Conrad?

[Laughter.]

Chairman GREGG. Cheeriness.

Just to return to the issue which you ended up on, and we are going to stick to the 5-minute rule; we have a lot of members, which is great. Willie Sutton used to say you rob banks because that is where the money was. And if you are looking at the long-term fiscal solvency of the Nation and how we address the deficit, it is fairly obvious from your numbers that it is in the entitlement accounts that we have to show the most management; is that correct?

Mr. HOLTZ-EAKIN. Yes.

Chairman GREGG. And within those accounts, the ones that are driving the largest amount of increase, as you said, Social Security would be overtaken by health care, the health care accounts, primarily Medicare and Medicaid; is that correct?

Mr. HOLTZ-EAKIN. That is correct.

Chairman GREGG. Now, we have just put on the books a new Medicare benefit, which is the drug benefit. Do you have any estimates as to where that drug benefit is going and how much it will cost and how it is rising in relationship to what the original estimates were, which that it would be $400 billion over 10 years?

Mr. HOLTZ-EAKIN. We do not track the subsequent cost of legislation that has been passed. To the extent that we can do an apples-to-apples comparison, we can look at the baseline outlays for the Part D benefit under Medicare; about $1.1 trillion over the 10-year budget window. That is in line with the original cost estimate.

The cost estimate, as it was in the bill, included some impacts on other Federal programs that we do not pull out and track separately in the baseline. So to the best of our knowledge thus far, the cost of the drug bill is essentially unchanged. It has crept up by about $5 billion compared to the $400 billion on the pieces that we can compare. Drug spending is growing more rapidly than health care spending as a whole, but it still represents a relatively small share, 10 percent of the kinds of outlays we face.

Chairman GREGG. Do you have the capacity to break those numbers out?

Mr. HOLTZ-EAKIN. Once the bill is passed and put into the various baselines, Medicare, Medicaid, FEHBP, and all those other things, we cannot track the exact configuration that was in the bill as it was passed. We can show you and are happy to the pieces that we track separately and their comparison to the original cost, and there, they are up only modestly, about $5 billion.

Chairman GREGG. So you cannot do a Part D estimate.

Mr. HOLTZ-EAKIN. We cannot do the MMA reestimate circa 2005. We can just look at the Part D as it appears in our baseline and that part of the MMA as it appeared in the original cost estimate.

Chairman GREGG. And in the area of Medicaid, what are you projecting there in relationship to the baseline?

Mr. HOLTZ-EAKIN. Medicaid spending is growing a bit under 8 percent per year. It grows more slowly than Medicare, in part due to legislation. The expiration of the extra Medicaid match that was in the JGTRRA provision makes growth a little slower, and the MMA moved the responsibility for prescription drugs from Medicaid to Medicare for those who are eligible for both programs, and that makes the 10-year growth a bit slower.

Over the longer term, the core source of growth is rising health care costs in the United States, the underlying cost pressures, not the particular structures of these programs.

Chairman GREGG. Looking at the discretionary accounts, if you take out the cost of fighting the war, it appears that the discretionary accounts were relatively flat in their rate of growth; is that correct?

Mr. HOLTZ-EAKIN. If one takes out the appropriations, you see the most recent year as I displayed on the chart, total growth at about 5 percent.

Chairman GREGG. And what are you projecting for the next 5 years in those accounts?

Mr. HOLTZ-EAKIN. Past the appropriations each year, we simply assume growth at the rate of inflation. Our inflation rate is going a bit above 2 percent per year over the budget window.

Chairman GREGG. And I notice that you are projecting that the revenues of the Federal Government are going to go up by approximately 6 percent, did you say?

Mr. HOLTZ-EAKIN. They are going to grow fairly rapidly, under 9 percent per year.

Chairman GREGG. And that is, in the first period, before the extension issue comes into play, what are you projecting revenue growth to be?

Mr. HOLTZ-EAKIN. Over the first 5 years, total revenue growth will grow at 8.7 percent per year on average.

Chairman GREGG. So even with the tax cuts, you are talking about revenues going up significantly.

Mr. HOLTZ-EAKIN. Yes; over the 5 years, there is a bit of legislation that comes into play with dividends and capital gains, but we are getting some from recovery in the economy and some from a resumption of capital gains revenues closer to normal.

Chairman GREGG. You are probably getting some from the dynamic fact that people with more income are more productive.

Mr. HOLTZ-EAKIN. We hope that our baseline incorporates the incentives that come with current law fiscal policy; they are constructed to do so.

Chairman GREGG. Your baseline seems to be fairly constrained in that you always assume that spending programs go on forever, even if their authorizations terminate, but you assume that the tax liability of the American citizenry will go up if the tax law is not extended. Why would we make those seemingly inconsistent assumptions?

Mr. HOLTZ-EAKIN. Well, we would be happy to work with the Budget Committee if there is an alternative set of assumptions that you would like to pursue for preparing baselines. The intent is to provide a neutral benchmark against which you can measure changes from current policy.

Chairman GREGG. Well, I guess my point is I understand you are constrained.

Mr. HOLTZ-EAKIN. Yes.

Chairman GREGG. And that is not your fault. But it does seem to me to be inconsistent in its constraining efforts. I mean, let us assume that if an authorization is sunsetted, why not assume that the program ends if you are going to say that when a tax rate sunsets, it is going to go up? I mean, you are handling one one way and another one another way; it just seems to me that it is not appropriate to getting a level playing field for reviewing the two.

My time is about up; I will yield to Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

What is the 75-year shortfall in Social Security?

Mr. HOLTZ-EAKIN. CBO's estimate of the 75-year shortfall as a fraction of GDP is about 0.4.

Senator CONRAD. Expressed in dollar terms, present-day dollar terms, what would the shortfall in Social Security be?

Mr. HOLTZ-EAKIN. Over the infinite horizon, it is $6.7 trillion.

Senator CONRAD. Over the 75-year.

Mr. HOLTZ-EAKIN. I do not seem to have that number in front of me.

Senator CONRAD. I think it is $3.7 trillion.

Mr. HOLTZ-EAKIN. It would be similar to the Social Security Administration, a bit smaller.

Senator CONRAD. Does $3.7 trillion sound about right as the 75-year shortfall?

Mr. HOLTZ-EAKIN. That is the Trustees' number. Ours would be a bit lower. We assume higher interest rates.

Senator CONRAD. Yours would be somewhat lower. What is the 75-year shortfall in Medicare?

Mr. HOLTZ-EAKIN. That number, I do not know how to calculate, quite frankly. Given historic rates of growth of Medicare and Medicaid, health care in general, 2.5 percent faster than income per capita. It is not obvious how to do that calculation without assuming something grows slower in the future, and so, the range of possible answers is enormous. I could essentially make up any number by assuming a future slowdown in costs.

Senator CONRAD. Well, let me ask you this: do you think that it is safe to assume that the 75-year shortfall in Medicare dwarfs the 75-year shortfall in Social Security?

Mr. HOLTZ-EAKIN. Absolutely.

Senator CONRAD. Do you have any estimate of what the 75-year cost of making the tax cuts permanent would be?

Mr. HOLTZ-EAKIN. We have never done such an estimate. The report contains an alternative to the baseline that says that the impact in 2015 is about 2 percent of GDP, it is a bit under. There is no reason to think that that fraction of the economy would be dramatically different going forward.

Senator CONRAD. I have an estimate that the 75-year cost of making the tax cuts permanent is $11.6 trillion. I would ask you to do an analysis of that. I would like to see what your numbers are, but that is in the range of the 75-year shortfall in Medicare and substantially more than the 75-year shortfall in Social Security. When you calculate the long-term imbalances in Social Security, what growth rate are you assuming?

Mr. HOLTZ-EAKIN. In our analysis of Social Security, we assume that long run real wage growth, which is the reflection of productivity growth in the United States, is 1.3 percent per year; the other factor that figures into overall economic growth is how many bodies will be available to take advantage of that, and there, we are going to have labor force growth that is on the order of a half a percent per year. It depends——

Senator CONRAD. So to come up with this calculation of long-term shortfall in Social Security you would be estimating an economic growth rate of about 1.8 percent; is that correct?

Mr. HOLTZ-EAKIN. Thereabouts; we can get the exact number.

Senator CONRAD. And what was the economic growth rate last year?

Mr. HOLTZ-EAKIN. Last year, we had a very good year. We do not know the final number for the fourth quarter yet, but it looks to be in the neighborhood of 4 percent.

Senator CONRAD. Four percent. And over the last 10 years, what has the economic growth rate been?

Mr. HOLTZ-EAKIN. I do not know off the top of my head but well below four.

Senator CONRAD. And one of the things I would be interested in. If the economic growth rate was 2.5 percent instead of 1.8 percent, what would that do to the estimates of long-term Social Security solvency?

Mr. HOLTZ-EAKIN. Productivity growth is not a panacea for Social Security. To the extent that we experience higher or lower productivity growth, it is reflected in real wages. Those real wages do provide higher payroll taxes into the Federal budget, but they also give the recipients higher benefit awards out of the Federal budget. Over the long-term, it is essentially neutral with respect to productivity.

Senator CONRAD. And what about economic growth?

Mr. HOLTZ-EAKIN. That is the key source of long-term economic growth. One could imagine a shift in the demographics, which raise the total growth rate because there was a larger growth in the labor force. There, I think the key uncertainty would be the path of future immigration, which is, I think, central. The native-born population at the moment is not replacing itself. The fertility rates are below replacement.

So all future population growth is ultimately derivative of immigration and immigration policy, and that will be the key uncertainty going forward.

Senator CONRAD. You know, I would imagine somebody listening to this at home must be utterly confused. I think it is hard to get your mind around the concept that economic growth is a product of productivity growth and the growth of the population. That is what you are saying to us this morning. And one of the key elements in population growth is how much immigration we have.

What I hear you saying is that if there is more immigration, that would actually extend the solvency of Social Security.

Mr. HOLTZ-EAKIN. It certainly would be an important part of long-term economic growth. As I said at the outset, I think it is important to recognize that we are unlikely to grow our way out of this problem. We did a long-term budget outlook in December of 2003. Nothing has fundamentally changed since we produced that document. It suggests that between now and 2050, if we repeat in the future what we have experienced historically, Medicare, Medicaid and Social Security will be about 26 percent of GDP; the current Federal Government is about 20 percent, and economic growth will not dramatically alter that picture.

Senator CONRAD. Very good; thank you for that testimony.

Chairman GREGG. You have raised a huge issue, which is whether you can immigrate your way out of Social Security problems.

Senator ALEXANDER.

Senator ALEXANDER. Do you count illegal immigrants when you consider the number of people in the work force?

Mr. HOLTZ-EAKIN. We use for our projections the information provided by the Census, which we have from 2001 as the jumping off point. That would include both legal and illegal immigrants, and we then do our best to project over the next 10 years based on what we know from the Bureau of Labor Statistics and the Census an-

nual data, so they are in there in an approximate fashion. I will not pretend to have great precision.

Over the longer term, we use the Trustees' assumptions regarding the demographics in the United States.

Senator ALEXANDER. Do you have any—do you know how many illegal people are working, have jobs here?

Mr. HOLTZ-EAKIN. At this point in time, no. It is very difficult to know even legal immigration on a real time basis. Undocumented workers would be even harder.

Senator ALEXANDER. Your report says that the labor force participation rate has declined from its peak of 67 percent in 2000 to 66 percent today, which you said means that we have 2.2 million fewer workers, and in your conversation a moment ago, the suggestion was that, we have more contributions to the economy.

Bear Stearns has a report that came out this month that estimates there may be up to 20 million illegal immigrants in the United States, more than double the 9 million people estimated by the Census Bureau, and that illegal immigrants are gaining a larger share of the job market, so says Bear Stearns, and hold approximately 12 to 15 million jobs in the United States, 8 percent of the people working.

Now, if Bear Stearns is right, that would make a massive difference, would it not, in your figures about the number of people working? A 1-percent change in the work force is 2.2 million workers, according to your report. So if there are 5 percent more illegal immigrants here than we think, we could have a significantly larger contribution to the work force.

So let me ask the question this way: there is a good deal of talk and the President has suggested very strongly that in order to live by the rule of law which we preach in this country that we need to create a guest worker status for people who work in this country. If we were to do that, how might that affect your budget projections?

Mr. HOLTZ-EAKIN. Well, there are really two impacts to think about: one is the starting point, and the second is future growth. With respect to the starting point, to the extent that workers, legal or otherwise, are employed and show up in the employment survey, they are counted in terms of employment. To the extent that they produce output, and it is measured in the standard accounts, we have already got them.

If it is the case that a new policy toward immigration altered the growth of the labor force going forward, that would be a greater increase in the economic resources available in the economy. Labor is a central input and would allow us to grow faster, other things equal.

Senator ALEXANDER. I would encourage you to explore how we count people who are illegally here working. I have had some conversations about it with Mr. Greenspan, and it seems to me unlikely that the employer survey, which surveys employers, is going to turn up an accurate count of people that they illegally hire. And if there are as many as 20 million people here, we need to get a better grasp on that, both for our budget debates and our debates about the rule of law and about immigration policy and about tax policy, and some part of our Government needs to help us under-

stand the number of people who are here and are not legally here and who have jobs.

Mr. HOLTZ-EAKIN. Well, Senator, I look forward to working with you on that. We are undertaking some work on immigration at the CBO and its impact on the budget and the economy more generally. I look forward to that.

Senator ALEXANDER. Thank you, Mr. Chairman.

Chairman GREGG. Thank you.

Senator STABENOW.

Senator STABENOW. Good morning.

Mr. HOLTZ-EAKIN. Good morning.

Senator STABENOW. And welcome, Mr. Chairman, to the Budget Committee. I look forward to working with you.

You have spoken about policy choices, and that is really our responsibility, working together to look at the values and priorities of the country and how they are reflected through the budget, just as we do that in our own checkbook when we look at where we spend our dollars.

I want to speak about that for a moment, because it is my understanding that we are going to see from the administration cuts in investments in education, cuts in veterans' health care; at the same time, a supplemental that will be about $80 billion for Iraq, and I have supported those, the funding for Iraq. But the 1-year funding, the $80 billion equals, in fact, surpasses the 1-year funding of the Department of Education and the Department of Veterans Affairs. So I raise that just to say this is always about choices, values and priorities.

I want to speak specifically about Social Security with you today, though. In speaking about Social Security, when you are talking about entitlements and the spending of the Federal Government, I think it is important for us to remember and to say Social Security is privately funded, is it not? We pay into it. We pay through payroll taxes into that system. It is privately funded. It is an insurance policy. It is the way we decide, just like you buy car insurance or home insurance, we pay into an economic insurance policy that insures us at retirement that we will not be in poverty or that if we are disabled, we will have an insurance policy, or if we have minor children, and heaven forbid, something happens to us, that they will have a life insurance policy.

So it is an insurance system paid into privately, and it is about choices when we look at whether that is a good program for the future or whether we do other things. And I wanted just to return to what Senator Conrad had said: there are various numbers, but it appears that the 75-year shortfall in Social Security is around $3.7 trillion; some have actually said it is actually less, $2 trillion, but we will take the higher number of $3.7 trillion.

When we look at making the tax cuts permanent over 75 years, we are looking at roughly $11.6 trillion. So what we doing is saying that those who have done well, have been blessed in our country will be receiving more than three times in the tax cut what the entire shortfall of Social Security is over 75 years.

And one of the things that I want to put forward in the Committee in the debate is the proposition that we would say to those most blessed, who have worked hard, obviously, I am sure, but who

breathe the air and drink the water and are secured by our troops in Iraq and around the world and drive on our roads and benefit from all of the blessings of the United States that they take 70 percent of the tax cut over the next 75 years, 70 percent, and we could secure Social Security for the next 75 years. I think that is an important value statement. It is an important priority.

And now, to questions: let me just say is it not according to your estimates, the CBO budget outlook, Social Security will, in fact, take in more than it pays out in each of the next 10 years; is that correct?

Mr. HOLTZ-EAKIN. Our most recent estimates are that the surplus in Social Security, taxes above benefits paid out, will remain positive until 2020.

Senator STABENOW. OK; and so over the next 10-year budget window, Social Security will take in about $2.6 trillion more than it pays out, roughly. Is that what you are looking at? So it does face long-term challenges, we understand, after the 2052 that you have estimated. It can pay about 80 percent of its benefits; is that——

Mr. HOLTZ-EAKIN. We would expect that upon Trust Fund exhaustion, current estimate is 2052, not a lot of precision there, I would admit.

Senator STABENOW. Right.

Mr. HOLTZ-EAKIN. But there would be about a 22 percent across the board reduction necessary to balance.

Senator STABENOW. So, 22 percent, so 78 percent roughly. So we do have a challenge that we do need to fix working together long-term.

My question would be, though, is not the rising cost of health care more of a challenge for us right now, not just Medicare and Medicaid, but large and small businesses in my State have had over an average 11 percent increase in their health care costs, and is that not a tremendous challenge and drain on the economy right now, and is health care not much more of a real crisis that we ought to be focused on?

Mr. HOLTZ-EAKIN. I think that the central domestic policy challenge that is evident at the moment is the rising cost of health care. It has a public sector evidence in the rising cost of Medicare and Medicaid. It has private sector implications for insurance and for the composition of wages versus fringe benefits. It is a very important issue. It will evolve in the same budgetary context as Social Security will over the next decades.

Senator STABENOW. Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

Senator ENZI.

Senator ENZI. I want to congratulate you for your assumption of the chairmanship, Mr. Chairman.

Chairman GREGG. I am sure you do.

[Laughter.]

Senator ENZI. I also want to thank Director Holtz-Eakin for being here today, too, and for the insightful information he has provided both verbally and in the more extensive testimony.

We've talked about balancing the budget. Recently, I looked to see how we balanced it before. I wanted to see what kinds of cuts

we had made in the budget in order to balance the budget in the late 1990's. I noticed we had not reduced the budget in any one of those years; that we grew the budget every single time. It appeared to me that the difference was we took in more revenue, which allowed us to spend more revenue.

I noticed last year in the budget and again in appropriations that the President found 65 different programs that had failed their own evaluation based on their own criteria. Under the Government Performance and Results Act, they had listed what their goals were going to be, and then, in their evaluation of whether they had achieved those goals, they failed; 65 programs.

We suggested those programs be eliminated, and there was not a one of them eliminated, not a one. Of course, the comment I heard was that the cut was only $5 billion. Now, anybody around here who says only $5 billion may have been here too long. That sounds like a lot of money to me. Yet, if we cannot start with eliminating $5 billion, we certainly are not going to be able to eliminate $500 billion.

But after looking at it, it looks like growing the economy has been the key to balnacing the budget, not what we did with programs. Is that a correct assumption based on when we had a balanced budget?

Mr. HOLTZ-EAKIN. The swing from deficit to ultimately surplus in the late 1990's was the net effect of slow discretionary spending growth and, in particular, a very large investment boom that was reflected in large amounts of equity-based compensation and ultimately tax receipts in the United States.

Senator ENZI. When we did the tax cuts, part of those tax cuts were business incentives. If those business incentives run out, how would that affect the productivity? Have you made any estimates on that?

Mr. HOLTZ-EAKIN. Which particular tax provisions are—the 2001, 2003 or earlier?

Senator ENZI. The more recent ones.

Mr. HOLTZ-EAKIN. We have looked fairly carefully at the impact of the partial expensing provision that was in the JGTRRA act, the Job Creation and Worker Assistance Act and then expanded. It appears that it has a modest stimulative effect on business investment, and we have been looking fairly carefully to see if its expiration at the end of 2004 would affect the timing of investment, though so far, there does not appear to be a dramatic amount of evidence that it really significantly pushed investment into 2004 at the expense of 2005.

Senator ENZI. Thank you. There is also some confusion or interest in the difference between the payroll and the household survey on the amount of employment. Which survey do you think more accurately measures job creation, and what is your opinion of why there has been a sustained gap between these figures?

Mr. HOLTZ-EAKIN. Both surveys have their virtues, and any projection that used one to the exclusion of the others is probably unwise. We rely heavily on the employment survey. It is a broader survey. It has historically been very successful at tracking employment. The household survey has known advantages in picking up

startups and in many other sorts of transitions into business. We look at both in the course of putting together our estimates.

Senator ENZI. Thank you.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

Senator NELSON.

Senator NELSON. Thank you, Mr. Chairman.

Good morning, Mr. Director. Would you mind holding up your chart right there? Yes, please. In your statement, it is my understanding that you clearly acknowledge that that chart does not reflect the cost of the war.

Mr. HOLTZ-EAKIN. That is right. There is no accommodation for appropriations in Iraq and Afghanistan from 1905 and thereafter.

Senator NELSON. And that would not, that chart would not reflect the reflection of if the President's proposal on Social Security, on privatization, and a transfer of those costs, that is not reflected in that chart.

Mr. HOLTZ-EAKIN. No, it is a baseline, has only current law.

Senator NELSON. And would not reflect if we do the alternate minimum tax reform. That is not reflected in that chart either.

Mr. HOLTZ-EAKIN. No, this is current law on the AMT.

Senator NELSON. And that would not reflect the additional debt service that would go along with those additional expenditures as well.

Mr. HOLTZ-EAKIN. No.

Senator NELSON. All right; then, that being the case, may I—all right; if you would show the other chart, the question is are we going to do the President's plan on Social Security privatization, which would cost about $1.9 trillion over 10 years; the cost of making the tax cuts permanent, which is about $1.6 trillion; the ongoing funding for the war, which obviously, we are going to appropriate $426 billion; the defense buildup as indicated by the administration, another $230 billion; AMT, alternate minimum tax, which certainly, there is going to have to be relief there, and therefore, reforming it is a very expensive item, $642 billion, and the debt service on all of that in excess of a half a trillion over a 10-year period.

If that is what happens, is that not more of an accurate reflection of what happens to the deficit over the next 10 years?

Mr. HOLTZ-EAKIN. Well, certainly under an alternative policy projection, something like that might transpire. To be perfectly honest, I do not know what Social Security would look like, and an alternative minimum tax reform, again, I do not know exactly what that would look like, but qualitatively, that would be the kinds of implications you would have.

Senator NELSON. Mr. Chairman, and our Ranking Member, I merely raise this point: yesterday, I had the privilege of speaking to what is known as the Forum Club. It is a bipartisan group that comes together in this case in Palm Beach County, in West Palm Beach, and we were talking about the question of the deficit.

And there are so many figures flowing around, as you pointed out, Senator Conrad. And when you see a chart like that, it does not reflect the actual realities that we have to face, and so, as we judge the question of what we are going to do with Social Security,

we have to be more realistic. There is not one of us here who is not going to support, with every dollar needed, our troops in the war, because it is in the interest, clearly, of the United States that we stabilize Iraq; otherwise, a vacuum would be filled by chaos and by terrorists.

And so, as we do these projections, I would encourage us to look realistically at what we are looking at and then see the actual deficit figures, what they are going to be, and see the fact of how we are going to finance those figures. And the shocking thing is that of the debt that we went out and borrowed last year, almost all of it was borrowed from foreign sources. And the two biggest sources that we are borrowing from are banks in Japan and China, and this is just simply not a good position for us from a defense posture to be in.

So thank you, Mr. Chairman, for the time to make this point.

Chairman GREGG. Thank you, Senator.

Senator ALLARD.

Senator ALLARD. Mr. Chairman, I would also like to congratulate you on your chairmanship, and I do not have the conflict of interest that my esteemed colleague did here in Wyoming, but I do think you will do a great job for us. I am looking forward to working with you.

You know, the $3.7 trillion that we saw put up on the charts here that goes out for 75 years, and I think 75 years is a ridiculous kind of—I mean, if what we are looking at here on your chart is apt to be wrong, 75 years out is certainly likely to be wrong. And the question I want to know, does that figure incorporate current law?

Mr. HOLTZ-EAKIN. Yes.

Senator ALLARD. So in 2042, when we have a 30 percent cut in Social Security, that is incorporated in those figures?

Mr. HOLTZ-EAKIN. The gap that is reflected in those figures, and those are not ours; those are from the Social Security Administration——

Senator ALLARD. Yes.

Mr. HOLTZ-EAKIN [continuing]. But ours would be qualitatively similar is the gap between benefits as scheduled under current law, and they stay above revenues, as scheduled under current law, as far as the eye can see, and so, the question is how do you add up that gap over different horizons?

Senator ALLARD. But the point that I am getting to is that 2042, I think, is what the Social Security Administration——

Mr. HOLTZ-EAKIN. Right.

Senator ALLARD [continuing]. Has said that the Trust Fund will be spent out. I mean, all of the money in the Trust Fund of Social Security will be spent in 2042; that is their figures. Now, what current law provides for, as I understand it, is that then, money that goes in is expended out, so you are no longer relying on those Trust Funds that have been borrowed from the General Fund to sustain those payments.

So the assumption is that there is a 30 percent, when the Social Security—all of the debt that has been paid out of Social Security has been paid in, paid out to the beneficiaries, you have a third cut

in benefits to Social Security. That is current law. And what they are figuring, what I see putting in these charts, they put that cut.

So I am assuming that everybody on that side thinks that cutting Social Security in 2042 is a good idea, because that is the figures they are using, and that is what they are using to somehow or the other discredit these tax cuts that have been proposed by the President, and many of us have supported. I just do not think in the real world that there is going to be a one-third cut in Social Security benefits to Social Security beneficiaries in 2042. And I think if we project out without that one-third cut, I think that what we will find is that Social Security will actually spend more than what the tax cuts have, and I would like to see some figures where we actually take Social Security, Medicare and Medicaid and combine them and look at their growth 75 years down the road, and I think when we are finished, we will find that is a lot more expensive than any of the tax cuts. Would you agree with that?

Mr. HOLTZ-EAKIN. I can give you the numbers, and you can decide for yourself. Between now and 2050, Social Security will rise from about 4 percent of GDP up to about 6.5 percent of GDP, so 2.5 percentage points of GDP.

Senator ALLARD. Which includes the one-third cuts in benefits in Social Security.

Mr. HOLTZ-EAKIN. That is prior to the cut.

Senator ALLARD. That is current law.

Mr. HOLTZ-EAKIN. That is prior to the cut.

Senator ALLARD. Yes.

Mr. HOLTZ-EAKIN. It will then proceed along in excess of receipts until Trust Fund exhaustion and the cut.

Senator ALLARD. Sure.

Mr. HOLTZ-EAKIN. Medicare and Medicaid over the same horizon could rise anywhere from 4 percent of GDP to either 12 or maybe even 20 percent of GDP, given the growth of health care costs. And these are numbers that we have outlined in our 2003 report. There is a large growth on the outlay side that will have to somehow be addressed, because it is unlikely that especially if the health care programs grow that large that we could ever finance them.

Senator ALLARD. Do you think in your own mind that it is likely that the one-third cut proposed in Social Security in 2042 under current law is going to sustain?

Mr. HOLTZ-EAKIN. That is a policy call, as you know. It is current law that if that is——

Senator ALLARD. But historically, those kinds of cuts in entitlement spending have not occurred, have they?

Mr. HOLTZ-EAKIN. The fact that that is the current law projection, and that is how the program can sustain forever, the crucial policy issue will be that the rising benefits above dedicated payrolls will occur simultaneously in the budget with rising demands for resources from the health care programs especially and then others as well, and that what ultimately will have to prevail will be some sort of adjudication of the demands for spending with the financing that is put in place. It will happen in all programs.

Senator ALLARD. So if benefits were to sustain themselves at what is projected, and, you know, if you were not to have that cut; it was projected out over time, you would have to have increases

in taxes and increases and cuts in spending in other programs to sustain that.

Mr. HOLTZ-EAKIN. Our projections show that——

Senator ALLARD. Or cuts in benefits, I guess, to the——

Mr. HOLTZ-EAKIN. Scheduled benefits under current law remain 2 percentage points above scheduled taxes and receipts under current law for the Social Security program out at the end of our 100-year horizon. So that is the mismatch in scheduled benefits and scheduled revenues.

Senator ALLARD. I think to try and extrapolate something out for 75 years is just insane.

Senator DOMENICI. Senator, would you yield just for a clarification?

Senator ALLARD. My time is up, but go ahead.

Senator DOMENICI. I ask unanimous consent for——

Chairman GREGG. Yes.

Senator DOMENICI. What is 1 percent of GDP, so everybody that listens to——

Mr. HOLTZ-EAKIN. Currently, this is about $120 billion.

Senator DOMENICI. Every time you mention that $120 billion.

Mr. HOLTZ-EAKIN. Yes, and you can think of, thus, you can think of any future number in terms of currently having to come up with $120 billion per percent of GDP.

Senator DOMENICI. Thank you very much.

Chairman GREGG. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman, and I look forward to your leadership of the Committee and working with you in very difficult circumstances. As a matter of fact, some of the issues we talk about here I hope actually have a constructive impact on my future life, particularly Medicaid and some of the other issues that are so important on the agenda of our budget efforts here.

I am curious here: you are very clear about the structure of Social Security. You talk about rising to 6.2 percent of the overall budget, but when we get to these Medicaid and Medicare costs, it is a little foggier in judgment, and I like the line of questioning of the Chairman and Ranking Member. Is it possible that we can sort through some of these discussions? You are saying that you did come up with a number of roughly 25 or 26 percent of the budget, did I hear you say, for mandatory spending or entitlement spendings?

Mr. HOLTZ-EAKIN. Mandatory spending is over half of Federal spending right now.

Senator CORZINE. But these entitlements, Medicaid.

Mr. HOLTZ-EAKIN. Those three, Medicare, Medicaid, and Social Security, will rise to be over half by 2015 and then will continue to grow.

Senator CORZINE. Right; and Social Security is what percentage of that 50 percent or——

Mr. HOLTZ-EAKIN. Currently, it is $500 billion, and Medicaid and Medicare are a bit below it, so it is a bit above half, but in the next 10 years, Medicare and Medicaid are projected to exceed it. I do not know the exact percentage.

Senator CORZINE. And their pace of growth is at a higher trajectory than what Social Security projections are.

Mr. HOLTZ-EAKIN. Yes; all the programs grow, because, as the baby boom retires, there are more beneficiaries. It is also the case that health care costs per person have grown much faster than income per person over the long-term, and that is an additional source of growth in those programs.

Senator CORZINE. And if I am not mistaken, last year, we added Part D to this program.

Mr. HOLTZ-EAKIN. Yes.

Senator CORZINE. It is hard for me to quite understand how we believe that Social Security—I do not expect you to opine on this, but how we think Social Security is in such a crisis when it is becoming a diminishing proportion of the overall mandatory social safety net programs that we have that are protected. Particularly in the context that we as a Congress just decided that we wanted to put a Medicare prescription drug plan down that is going to increase those elements. I would just, if you wanted to opine on which was in crisis, I would ask you, but I can understand——

Mr. HOLTZ-EAKIN. I think CBO directors are allergic to words like crisis.

Senator CORZINE. Right; I think that one has to put these in the overall context of what is actually going to be driving expenditures as we go through time. It certainly looks like Social Security is one that has options that are relatively certain. You know, we talk about not ever having reduced benefits. I think we extended—the Greenspan Commission extended the time when retirees would receive benefits, which, you know, call it whatever you want, those people who are missing it for a year or two versus when they were was a discretionary judgment that Congress came to.

So if Senator Nelson's projections are, you know, rough justice true, do I have this right that we will be running cumulative deficits—I think he had something like $5.4 trillion? That would add to this $855 billion that you would say is a cumulative deficit over the next 10 years.

Mr. HOLTZ-EAKIN. Yes, if those proposals——

Senator CORZINE. If those projections are right.

What implications would that have, in your view, on the cost of money and the country's ability to manage its current account deficit, and what kinds of economic implications does our borrowing $6.5 trillion versus $855 billion have? What would be the kinds of things you would expect from that kind of change in——

Mr. HOLTZ-EAKIN. Let me do it in two steps. First, if one looks at the trajectory exclusive of a Social Security proposal, deficits on average move the country's economic activity away from saving and toward consumption, and that, over the long haul, lowers our accumulation of wealth, of capital, of technologies, of education, and slows economic growth.

Senator CORZINE. That lowers that productivity curve, I presume, if we are to do that.

Mr. HOLTZ-EAKIN. Yes, and there may be, you know, capital market manifestations of that in terms of higher interest rates, lower exchange rates; the exact combination is not clear. But the core economic impact is to save and accumulate less for the future.

The Social Security piece is harder, because without knowing the details, there are two pieces. One is what is done to the underlying

program, the mismatch between benefits up here and dedicated receipts below it, and then, what is done in any Commission Plan Two-style individual accounts.

And if one just looks at borrowing money and putting it in individual accounts, the economic ramifications are a bit different, because that is from a national perspective a wash initially, and any economic ramifications would come from changes in individuals' perceptions of the future, and that would probably hinge on what was done in the underlying program. So it is not easy to spell out what would happen to the economy there.

Chairman GREGG. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

Just as a comment on Senator Nelson's chart, that chart assumed that the Congress of the United States would do nothing, change no laws, change no tax law, change no Social Security law, change nothing, and that would be the result if we did nothing.

Mr. HOLTZ-EAKIN. I will let the Senator speak for his own chart, but I do not think that is what he showed. He showed something which had a proactive change in the alternative minimum tax; a proactive change in Social Security law, and I forget the exact list.

Chairman GREGG. If the Senator would yield, it also had a $2.9 trillion number in there for Social Security borrowing.

Senator BUNNING. Oh, yes.

Chairman GREGG. And that would be new policy, plus, he double-counted it, because first, he counted it as a direct—he directed that borrowing to the bottom line of the deficit, which is sort of ironic, because it is borrowing, and then, he counted the interest on top of that to the bottom line of the deficit, so the numbers themselves were a little confusing.

Senator BUNNING. There were many changes that we had not made.

Chairman GREGG. Yes.

Senator CONRAD. Mr. Chairman, if I might just intercede——

Senator BUNNING. May I finish and then go ahead, Kent? After I get finished, you can do whatever you want as vice-chairman of this Committee.

Yes; I just am amazed that 2080 is 75 years from today; 2080, there is not going to be too many people in this room still on this side of the Earth. And now, we are trying to project, because we have a law that says we must project, solvency for the Social Security for 75 years, solvency, not a 30 percent reduction in the year 2042 or 2043; not in 13 years going from a positive inflow to a negative inflow in the amount of money coming in; yes, I know in 2018, there is an inflow that starts downward, and then, our supposedly, bonds will pay the taxes well enough to pay full benefits into 2042 or 2043.

And then, that chart also showed that—or did not show that there would be about a 30 percent reduction starting in that year on Social Security benefits if current law were left like it is. I want the American people to understand, we do not want to do that. That is doing nothing about Social Security. We want the people now collecting it to collect the full amount, and I want my 35 grandkids and my nine children and their spouses to be able to collect the full amount that they expect.

And if we do not do something, and we do not do it shortly, 13 years maybe; why not do it before the 13 years? It is a lot easier to do it up front. We are going to be short, big time short, depending on who adds up the numbers, whether it is $4 trillion, whether it is $10 trillion. As an economist, would you comment on the likelihood, economics and behavioral effect of Congress not extending the tax cuts, including individual tax rates and capital gains and dividend tax rates currently set to expire within the budget window?

What effect would such a large tax increase have on economic growth? How would it physically or potentially affect the Social Security solvency?

Mr. HOLTZ-EAKIN. Two different questions. The first is the impact of letting those tax cuts go away as under current law would depend on what people are expecting. If people expect dividends and capital gains rates to remain at their current level past 2009, the rise would raise the cost of capital; it would serve in the long-term to diminish their spendable income, and they would presumably choose, as a result, to consume less and save more.

Similar impacts could be expected in 2011. If they expect those to be made permanent, and they are not, that would be a surprise increase in taxes; they would feel worse off. They would save more to make up for it, and it would impact incentives to save, invest and supply labor.

Senator BUNNING. And Social Security?

Mr. HOLTZ-EAKIN. Social Security is narrowly financed by a payroll tax, and the formula is determined by the growth in real wages. Only the impacts on real wages and payroll tax base would show up in Social Security.

Senator BUNNING. Would you call 12.5 percent narrowly? That is the payroll tax.

Mr. HOLTZ-EAKIN. I do not understand the question.

Senator BUNNING. If you say 6.25 from the individual and 6.25 from the corporate side, is that a narrow-based tax?

Mr. HOLTZ-EAKIN. I may not understand the question. I do not know of any changes in the payroll tax under current law, so if the question is if we changed one——

Senator BUNNING. Well, there is none proposed.

Mr. HOLTZ-EAKIN. If we changed it, it would have big economic impacts, yes.

Senator BUNNING. Thank you very much.

Chairman GREGG. Thank you.

Senator BYRD.

Senator BYRD. Thank you, Mr. Chairman.

I congratulate you on winning the election——

Chairman GREGG. Thank you.

Senator BYRD [continuing]. Which made you the Chairman. And I am going to look forward to working with you. I have found our past relations to be very cordial, and they will remain that way.

Mr. Director, I am not one of those who believes that Social Security can continue to pay benefits without changes 50 years into the future. A significant problem exists, and while it may not be on our doorstep, it certainly is on the horizon. The Congress has the re-

sponsibility to make the relevant facts known to the American public.

At a recent event hosted by the New America Foundation, you referenced the, quote, important details, close quote, that you hoped would emerge from a, quote, high-level discussion, close quote, about Social Security reform. When you say high level discussion, are you referring to conversations behind closed doors at the White House, or do you mean to encourage an open, public discussion in which all of the details of Social Security reform emerge?

Mr. HOLTZ-EAKIN. That was intended to convey the benefits I would receive from a vigorous public discussion that looked at all of the policy issues from an economic, from a budgetary, and from a programmatic perspective.

Senator BYRD. You might want to consider a point that I made in my letter to President Bush: what important details should the Congress know before it makes changes to Social Security?

Mr. HOLTZ-EAKIN. I think there are many dimensions to a Social Security proposal that will matter. It is well-established that the current program will, in fact, automatically come into balance, in our projections, in 2053. The question is is there a better way to bring the underlying program into balance, and what would that entail in the way of benefit changes and tax changes? In addition, there is a threshold question that has been discussed about the desirability of moving from a fully pay-as-you-go to a system that is at least in part prefunded. That is a threshold policy question, and one would need to understand both the nature of the transition at the beginning and how it would be financed and then also the interaction of any ultimate private investments and the traditional program as modified at the end.

There is an enormous number of details that are central to evaluating that from an economic policy point of view; certainly, its budgetary implications and then for the objectives of the program narrowly defined.

Senator BYRD. The people pay for Social Security. Before we make any changes in the program, the people have a right to know all of the details. I have written to the President and ask that he explain the full costs of his Social Security plan and its effect on workers' benefits. What else should we ensure that our constituencies know?

Mr. HOLTZ-EAKIN. I think the range of information is enormous. The distribution of benefits and taxes, both prior to and after any alteration of legislation; the range of options that would be involved in any new elements of the Social Security program, the interaction of the disability program with the retirement program; the list could go on and on.

Senator BYRD. What facts should the Congress require of the administration in order to make an informed decision about individual accounts?

Mr. HOLTZ-EAKIN. The Congress will probably decide in its own wisdom what facts it needs. I think that the legislative details of any proposal, individual accounts or otherwise, will have a very large impact, and knowing those details is central, at least in CBO's eyes, to giving an accurate assessment of the economic, budgetary and Social Security impacts.

Senator BYRD. In discussing investment accounts at the New America Foundation, you were asked about the Federal Government providing a financial guarantee that is comparable to the guarantee afforded under the current Social Security system. Assuming that the Government guarantees a minimum benefit from individual investment accounts, how much of a cost would that impose on the Federal budget?

Mr. HOLTZ-EAKIN. It is not possible to calculate a dollar amount of that cost without knowing the nature of any individual investments and also the size of the guarantee, the minimum benefit. It is just my observation that with the presence of market risk that market risk can be transferred to the Government and ultimately to the taxpayer, but it cannot be made to go away, and that accurately assessing such an investment strategy would involve accurately assessing the cost of risk.

Senator BYRD. Mr. Chairman, is my time up?

Chairman GREGG. I am afraid so, Senator.

Senator BYRD. I thank the Chairman.

I thank you, Mr. Director.

Chairman GREGG. Senator Domenici, the former chairman.

Senator DOMENICI. Thank you, Mr. Chairman.

First of all, let me not only congratulate you but say that I have wished for many things since I was a Senator, but I certainly do not wish to be in your place.

[Laughter.]

Chairman GREGG. Congratulations is faint praise.

Senator DOMENICI. But when I was working on budgets, and there were deficits comparable to this, people were saying the same thing: they did not want my job.

But let me suggest to all of you and Mr. Director to you also that the first chart you put up, put it up there again about where the deficit has been. See, that is a pretty good indication that the deficit changes rather dramatically. Do you see where it peaked out up there? That is a higher percent of GDP than we are now, substantially higher. So is the percent of GDP that accompanies a deficit an important number in terms of the American economy and what our people might expect in terms of their lifestyle?

Mr. HOLTZ-EAKIN. Yes, I think it is much more accurate to measure the deficit as a fraction of national income than just the dollar terms.

Senator DOMENICI. So it is important that that be as low as you can get during good times.

Mr. HOLTZ-EAKIN. One would expect that you, as a Federal Government, decide what programs you want to have and how much they will cost, and then, you put in a financing plan that supports it.

Senator DOMENICI. I am not sure I should ask you that question, because that is a sort of a policy thing. We should not be asking you those, but I think that is sort of well-understood. Now, look at it, and everybody look at it. Look how quickly it came down. You see, at the bottom end, it was balanced, right? Follow that green line. It was balanced for 2 years there. I might say to everybody I was privileged to be there when that happened.

[Laughter.]

Chairman GREGG. You did a great job.

Senator DOMENICI. Yes; that made up for all the pain.

[Laughter.]

Senator DOMENICI. I am not sure how long it will last if this other one keeps going up, but Mr. Director, did I hear you say that there is nothing on the horizon that would indicate that that deficit might not come down precipitously like it did in the years up there, part of the Clinton years and part of the Reagan years; did you say that?

Mr. HOLTZ-EAKIN. I cannot rule that out. As a matter of science, I cannot. The uncertainty is too large. I think that as a matter of the odds, it is unlikely that we will simply grow our way out of this deficit using current policy, but I certainly could not stipulate that it could not happen.

Senator DOMENICI. But we did grow our way out of that one.

Mr. HOLTZ-EAKIN. The growth in the late nineties, the big investment boom and the receipts that came with it were extraordinary, and I guess the sentiment I am conveying is it is unlikely to bet on that again.

Senator DOMENICI. That is the era when we have a lot of arguments as to what caused it. If you were on President Clinton's side, you would say his tax increases caused it. Some people say that. If you are on my side, I would say that is ludicrous; it was a lot of other things that caused it but not that.

In any event, to me, the most important thing is the economy and what happens to it and that there be sustained economic growth, not just for a few years but that we are not doing things that will hurt the economy in the out years. Everything we do ought to be measured against sustained economic growth, because the American people should know that those are fancy words, but that essentially means jobs; it means the potential for wages to go up and for more people to be employed.

Now, we do not have to have a balanced budget to have a good economy, do we?

Mr. HOLTZ-EAKIN. No.

Senator DOMENICI. And America, an economy as powerful and as strong as ours, can sustain and live with deficits; is that not right? We have.

Mr. HOLTZ-EAKIN. It is an issue of magnitude, sir. To the extent that there are enormously large deficits that reduce national saving, then, ultimately, growth will be impacted. But it is certainly the case that we have had good economic growth coexist with deficits.

Senator DOMENICI. Now, we should be concerned about getting the deficit down, because we have had a very large accumulation of deficits, which means that debt is getting very large. Is that a fair statement? Concerned about it; I did not ask how quick or how, but we should be concerned about it, right?

Mr. HOLTZ-EAKIN. I think that certainly, going forward, fiscal policy is central to the U.S. economic outlook. I would say that the years past this chart are as important as any.

Senator DOMENICI. Mr. Chairman, I do want to make one point. All this testimony, you know, we are listening to it, but so are a lot of people. And we use words that many people do not under-

stand. You know, he made a statement, if this happens, the cost of capital will go up. What does the average American know? What does that mean?

Chairman GREGG. Nobody understands that.

Senator DOMENICI. That means interest rates will go up; is that correct?

Mr. HOLTZ-EAKIN. It means interest rates will go up, and businesses will find it harder to finance their investments.

Senator DOMENICI. So, that is bad, right? I mean, for the economy, for jobs, for people.

Mr. HOLTZ-EAKIN. Yes.

Senator DOMENICI. My second question on that line—am I out of time? OK; will we get another round?

Chairman GREGG. Yes.

Senator DOMENICI. I will stay.

Chairman GREGG. Senator Murray.

Senator MURRAY. Mr. Chairman, thank you. I join with my colleagues in welcoming you to this new position. You take it at a very difficult time with all of the challenges that we certainly face in the country today.

I think we are the only two members of this Committee that are on this Committee, the HELP Committee and Appropriations, so we will be seeing a lot of the outfall of the decisions.

[Laughter.]

Senator MURRAY. Mr. Director, it is good to have you here as well. We all depend on your objective, unbiased outlook and assumptions; may not always agree with everything you say, but really do appreciate the work that you do, so we welcome you here today.

Mr. HOLTZ-EAKIN. Thank you.

Senator MURRAY. Mr. Director, the CBO's most recent economic outlook assumes an fiscal year 2005 deficit of $368 billion. You have acknowledged that that does not include any supplemental funding for Iraq or Afghanistan, any changes to the AMT or revenue changes from making the tax cuts permanent. If we simply include the additional supplemental spending, we are, I believe, looking at a deficit for 2005 of at least $420 billion, which is another historic high.

Now, I have heard the President say that he hopes to cut the deficit in half over the next 5 years, and excluding any funding for DOD or Homeland Security or revenue changes from extending the tax cuts, if we just look at the supplemental, what kind of cuts will we have to enact to Medicare and Medicaid and other mandatory programs in order to cut that deficit in half?

Mr. HOLTZ-EAKIN. Let me begin first with the fiscal year 1905 number. Our estimate would be that the outlays, the additional outlays in 1905 for Iraq and Afghanistan would total about $30 billion. Our estimate of the deficit would be about $400 billion. The administration estimated something close to $430 billion. That is consistent with our recent experience that on baseline, outlays that are about $20 billion higher than us, and spending on supplementals, they are a bit above us.

So we put the number closer to $400 billion. That is the one I would be comfortable with.

Senator MURRAY. Fine.

Mr. HOLTZ-EAKIN. Cutting it in half over the——

Senator MURRAY. Five years?

Mr. HOLTZ-EAKIN [continuing]. Next 5 years, I guess I would ask you starting from what point? Starting from $400 billion, you would have to get down to $200 billion. The arithmetic is pretty simple: you would have to take out $200 billion. If you did it as a fraction of GDP, it would be a bit less. Right now, $100 billion is about 42 percent of Medicare spending; Medicaid, it is a bit larger as a fraction of Medicaid, and those are mechanically the kinds of reductions in spending you would need to meet that kind of target.

Senator MURRAY. Including in education and transportation and veterans' health care and housing, and all of those programs would all have to take a cut of about 2 percent, correct?

Mr. HOLTZ-EAKIN. That is if we just did $100 billion in Medicare and Medicaid; the broader thing, you would have a wider base. It would be lower. We can get an estimate for you if you would like.

Senator MURRAY. But there would definitely have to be some significant cuts in mandatory programs and other programs as well.

Mr. HOLTZ-EAKIN. There would certainly have to be some reductions.

Senator MURRAY. I listened carefully to my friend from New Mexico, who chaired this Committee for a long time, and agree with him that the sustained economic outlook is critical to us getting our budget in control, but we also know that to keep jobs out there, we have to have education and training and transportation infrastructure in order to create and sustain those new jobs. So I am very concerned that enacting major cuts will have a bigger increase on the deficit and make it very hard for us to reach that deficit reduction if we are making big cuts in programs that actually help sustain and create jobs plus health care.

Mr. Director, you did point out that increases in Medicare and Medicaid reflect some of the overall increases in health care, and this administration has been arguing that caps on noneconomic damages on medical malpractice will slow increases in health care. Would caps on damages significantly reduce the Medicare and Medicaid costs that we are looking at?

Mr. HOLTZ-EAKIN. To the extent that we know the link between caps on damage awards and various costs in health care, our knowledge is pretty limited, but we did do some work that suggested that caps would reduce malpractice premiums significantly, by about 22 percent, but those are a small fraction of overall health care spending, and the impact on the broad spending basket would be under 1 percent.

So that is the extent of a statistical link between caps and health spending that we found so far. It is an area we continue to work in and are interested in learning more about.

Senator MURRAY. It is not going to save our way out of this?

Mr. HOLTZ-EAKIN. Not on what we know so far.

Senator MURRAY. It was not that long ago that this Committee was looking at a fairly large surplus, and here we are with historic highs in deficit spending. We have heard a lot about the war on terrorism, recession, increased spending on domestic programs all

contributing to this, but there is not a lot of talk about the impact of the tax cuts from 2001 and whether or not they have contributed to this deficit.

What role did the President's tax cuts play in our rapid escalation in annual deficits?

Mr. HOLTZ-EAKIN. There are two answers to that. The first is that mechanically, if one does the arithmetic and looks at the CBO's projection of the budget surplus for this year and now the reality of a deficit for this year and does a decomposition of the swing from surplus to deficit, about 35, 36 percent of that is economic impacts, economics and technicals; a comparable size, 35, 36, is on the spending side, and the remainder would be on the receipts side.

More generally, the swing from surplus to deficit on both tax and spending during the course of the early 2000 period, when the economy was very weak, on balance did support a very weak economy, and that, other things equal, was an economic benefit. It is just now the case that the economy has recovered. Going forward, we have a private sector-led economy, and those kinds of sustained budget deficits have a very big and different impact going forward than they do looking back.

Chairman GREGG. Thank you, Senator.

Senator MURRAY. Well, thank you, Mr. Chairman. I just would say that I am very concerned about the deficit spending. We are looking at the war in Iraq, continuing costs, supplementals, a lot of talk about Social Security. I believe our generation has the responsibility to look at this budget from an honest perspective and say what we are spending; we should not be passing these costs on the next generation.

Chairman GREGG. Senator Graham.

Senator GRAHAM. Thank you, Mr. Chairman. Congratulations. I am honored to be part of the Committee.

I asked you some questions before the hearing, and I do not know if you got the information or not, but if the Congress decided to make the tax cuts permanent, and we borrowed the transition costs of a personal investment account bill like I proposed, which is, I think, $1.2 trillion, did you find how that would affect the deficit?

Mr. HOLTZ-EAKIN. We took the policy that your staff conveyed and consisted of the taxes and AMT, Social Security. That would lead in 2015 to a deficit on the order of $650 billion and a total over the 10 years of about $5 trillion.

Senator GRAHAM. So to make sure we understand that, if you made the tax cuts permanent, and you borrowed the transition costs of personal investment accounts as described by my bill, one of the more modest ones, you would have a $650 billion deficit in 2015; is that correct?

Mr. HOLTZ-EAKIN. Yes.

Senator GRAHAM. All right; if you tried to make Social Security solvent just by putting new money without any other reform to 2075, how much money would you have to come up with in today's dollars?

Mr. HOLTZ-EAKIN. If the question is, you know, what would you need to solve the actuarial imbalance——

Senator GRAHAM. Right.

Mr. HOLTZ-EAKIN [continuing]. Then, that is a number that is on the order of $3.5 trillion, and the difference, of course, is in the timing, the gap between benefits and taxes.

Senator GRAHAM. OK; to avoid any benefit cuts between now and 2075, you would need $3.5 trillion in today's dollars right now.

Mr. HOLTZ-EAKIN. You would have to dedicate to Social Security those resources and find a way in the budget and the economy to get them.

Senator GRAHAM. OK; if you tried to solve the Social Security dilemma of reduced benefits coming over time, just by changing the age eligibility, how old would you have to be to meet that goal before you drew your first check?

Mr. HOLTZ-EAKIN. It is easiest for me to frame the long-term problem as the fact that benefits are about 7 percent of GDP; taxes are about 5 percent of GDP, so there is a gap out there for as far as the eye can see between promised benefits and taxes.

Raising the normal retirement age above 70, even to the midseventies, seems unlikely to close that gap.

Senator GRAHAM. So if you went up to 75 before you got your first check just by raising the age limit, it would not close the gap, you do not believe.

Mr. HOLTZ-EAKIN. We do not have a firm estimate, but it would take a substantial increase.

Senator GRAHAM. OK; there is a big issue going on debate in the country: is Social Security really a problem or not? Do we have a problem with the system? Whether it is 2042 or 2052, you are firm on the idea that we start paying more money out than we collect around 2020.

Mr. HOLTZ-EAKIN. I do not know what constitutes a problem, but I know the future. And the future is that at the moment, Social Security brings in more in payroll taxes than it pays out in benefits. Between now and roughly 2020, that would diminish and go to zero. Those funds would no longer be available to the remainder of the budget and cushion it, and thereafter, it will switch.

Senator GRAHAM. Well, if I started paying out—if I spent more than I took in, would I eventually have a problem?

Mr. HOLTZ-EAKIN. Yes, sir.

Senator GRAHAM. I would probably go to jail, because I would start writing bad checks, but that is not going to happen here.

So the bottom line is by 2020, in that timeframe, the country has to deal with a phenomenon that we are paying more in benefits than we are collecting in Social Security taxes. Are you sure about that?

Mr. HOLTZ-EAKIN. It is the case that this will evolve in a budgetary framework, and to the extent that——

Senator GRAHAM. Did you just say yes or no?

Mr. HOLTZ-EAKIN. No.

[Laughter.]

Mr. HOLTZ-EAKIN. It is the case that you could, you could, sir, as a matter of principle decide not to touch Social Security. But if you do that, you have to simultaneously address a larger budget problem everywhere else.

Senator GRAHAM. Right.

Mr. HOLTZ-EAKIN. And so, that is a policy problem.

Senator GRAHAM. That is not my question. My question is a very simple question: we have 12.4 percent payroll taxes coming into the system. We are going to pay benefits, and they have already been scheduled. There comes a point in time where the 12.4 percent does not equal the amount you are paying out.

Mr. HOLTZ-EAKIN. Yes, absolutely.

Senator GRAHAM. OK; and once that happens, bad things follow.

Mr. HOLTZ-EAKIN. Once that happens, you must find the way to honor those benefits which will be statutorily due from somewhere in the Federal budget.

Senator GRAHAM. OK; when do you believe Social Security really becomes stressed? Is it 2020, or does it happen before then?

Mr. HOLTZ-EAKIN. I believe that when viewed from a budgetary perspective, it will be the case that shortly after the baby boom begins to retire in 2008, that the cushion that the program is currently providing to the Federal budget will begin to diminish. That will be noticeable to members of the Budget Committee and Congress as a whole, and thereafter, it will not only diminish; it will switch, and funds to honor benefits payable under current law will have to be found by either cutting other spending programs, raising taxes, or borrowing more.

Senator GRAHAM. And one last comment. I have gone over my time my first appearance; I apologize. The basic problem is that in the future, we are going to have a lot more people come into the system as retirees than are workers; is that correct?

Mr. HOLTZ-EAKIN. That is right. There is a sharp ramp-up with the retirement of the baby boom generation.

Senator GRAHAM. Thank you.

Chairman GREGG. Senator Sarbanes.

I notice that nobody has turned their mike on when they welcome me to the Committee.

[Laughter.]

Senator SARBANES. Actually, now that the mike is on, I was going to repeat the welcome.

[Laughter.]

Senator SARBANES. I join my colleagues in welcoming you to the Committee, and we look forward to working closely with you, and I want, as always, to acknowledge the chairmanship of Senator Domenici for many, many years.

Senator DOMENICI. Thank you very much.

Senator SARBANES. I want to talk a bit about our international situation, but before I do that, I just want to be clear on this Social Security question. When you use these various projections, whose assumptions are you using with respect to growth of the economy?

Mr. HOLTZ-EAKIN. CBO's projections are built off of the 10-year baseline projections, so we use the same economic assumptions in our Social Security as we do for the budget outlook that you saw today.

Senator SARBANES. That is for 10 years.

Mr. HOLTZ-EAKIN. Yes, beyond that——

Senator SARBANES. Beyond that, are you using the Social Security system's projections?

Mr. HOLTZ-EAKIN. We will use the Trustees' assumptions for fertility, mortality, immigration, disability. We use CBO's economic assumptions for the entire period.

Senator SARBANES. I see. Now, the Trustees' assumptions generally, on the figures I have seen used, are really the most conservative path, are they not? Is that one of the reasons that you project that the Trust Fund will still have something in it in 2052 as opposed to their 2042?

Mr. HOLTZ-EAKIN. There are really two big differences that contribute to that. The first is we assume that real interest rates will be higher, 3.3 percent as opposed to 3 percent for the Trustees. Mechanically, that allows higher interest on bonds in the Trust Fund, and they last longer, and then, we have a bit lower in the way of male benefits paid, and so, there is less going out, and that tends to extend the Trust Fund.

Senator SARBANES. Now, on your projections, as I understand it, the system, including the Trust Fund balances, which have been built up for the purpose of paying the benefits, would be able to handle that at a 100 percent level until 2052; is that correct?

Mr. HOLTZ-EAKIN. Our indications are that the Trust Fund accounting would keep benefits fully payable until 2052.

Senator SARBANES. 2052.

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES. In other words, 47 years from now.

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES. Now, at that point, if all of these assumptions work out, and of course, we are assuming a lot of things, because we are talking about half a century in terms of what is going to happen, but at that point, assuming all these assumptions work out, there will not be any balances in the Trust Fund to help pay the benefits; is that correct?

Mr. HOLTZ-EAKIN. At that point, under current law, there would not be the legal authority to pay full benefits, and you could only pay payroll taxes coming in.

Senator SARBANES. Right; now, am I correct in understanding that payroll taxes coming in would still be sufficient to pay 75 to 80 percent of the benefits?

Mr. HOLTZ-EAKIN. Yes; our projection has it 78, but as you well know, there is enormous uncertainty over all these numbers. It is the trajectories that really matter.

Senator SARBANES. Yes; of course, the uncertainties run in both directions.

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES First of all, I would just make the comment that that does not sound to me as if the system is broke or insolvent. There is a shortfall which we need to address, and I recognize the sooner you address it, the smaller the adjustments you have to make; the longer you wait, the greater the adjustments you have to make. But even in 2052, if nothing else is done—and no one is operating on that premise—this inflow into the system would cover 75 to 80 percent of the benefits; is that correct?

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES. OK; now, I want to ask you about our international situation and the growing imbalances which exist inter-

nationally. It is my understanding that we are now running the largest trade deficit in our history.

Mr. HOLTZ-EAKIN. Yes.

Senator SARBANES. Now, that means, of course, that we are building up our external debt, does it not?

Mr. HOLTZ-EAKIN. Yes.

Chairman GREGG. Senator, your time is up, but if you want to continue this for a minute or so, because we are going to do another round.

Senator SARBANES. Oh, we are?

Chairman GREGG. I will give you a couple more minutes here, and then, we will start off on the other round.

Senator SARBANES. I will wait until the next round then; I will pursue that subject on that round. I do not want to impose on my colleagues.

Chairman GREGG. Thank you.

Just to followup on the line of thought that Senator Sarbanes has pursued here as to what really is the solvency of the Social Security fund, first, remember that this Committee's role in Social Security is prescribed by the statute, but all of us on this Committee have spent a lot of time working on the issue. But the point is this: the real issue that we confront is what Senator Graham points out, which is that we have a demographic adjustment in our nation coming at us, which is that historically, the genius of Social Security was that it was a pyramid.

There were always going to be many more working people paying into the system than people who took out of the system; originally, in 1950, there were 12 people paying in for every one person taking out; today, there are 3.5 for every one. By the year 2019, where there will be two people paying in for every one person taking out, we go from a pyramid to essentially a rectangle, and there are just simply too few people working to support the tax burden to support the people who are retired.

And the concept that there is a fund somewhere that is going to be redeemed that is going to be able to pay for the benefits is really a bit illusory, because what the fund is, is it is a put to the American taxpayer or a call to the American taxpayer, the working American, the American who is 20, 30 years old, the American, our children, our grandchildren who are coming into the work force saying you shall pay taxes to redeem these bonds to support these people who are retired.

And that tax burden has to go up to the point to support the benefit. So what we are basically saying is we are going to significantly increase the tax burden on those working Americans because there are so many fewer of them working to support the number of people retired; is that not correct?

Mr. HOLTZ-EAKIN. It is the case that there are no economic resources in the Trust Fund, and in order to avoid defaulting on the bonds in the Trust Fund, it will be the case that the Treasury will have to come up with funds from some source. There will be higher taxes or lower spending on other programs, or the Treasury will borrow from the public as a whole.

Chairman GREGG. So essentially, what is happening here is that you have a generation that is so large that it is going to end up

putting a tremendous burden on the younger working generation when it retires, and that was not conceived when the Social Security system was structured; it was always conceived that there would be a much larger working group, which is why we got into the immigration issue earlier on in this discussion, but I think it is important that people understand that, that there really is not some fund out there that people are going to be able to suddenly jump onto.

That must be my wife saying I am not smiling.

[Laughter.]

Mr. HOLTZ-EAKIN. I am not wearing the tie my wife bought me so——

Senator DOMENICI. I have a wife like that, too.

[Laughter.]

Chairman GREGG. I do think that point is critical to this whole debate of how we address Social Security.

I am not going to take any more time here, because I know that you have been very generous with your time, Mr. Director, and I have my wife calling me.

[Laughter.]

Chairman GREGG. So I will yield my time to Senator Domenici, I know, had some followup point, and then, we will go back and forth.

Senator DOMENICI. Thank you very much.

I want to tell you all one about wives calling. I was on the floor one night debating with Senator Kennedy, and, you know, we both have a tendency to yell.

[Laughter.]

Senator SARBANES. I have never noticed it.

[Laughter.]

Senator DOMENICI. And somehow, we both think that the louder and more red we get, the more effective we are.

Senator DOMENICI. And one night, my wife called and left a note and said please, the fact that you are getting louder and more red does not mean you are any more effective. In my opinion, you are getting worse.

So I went back, and when I got the floor, I changed it, and I said Senator Kennedy, my wife called and said that you and I were both yelling too much and getting too red——

[Laughter.]

Senator DOMENICI [continuing]. And she suggested that you tone it down.

[Laughter.]

Senator DOMENICI. When I got back home, my wife was really fit to be tied.

[Laughter.]

Senator DOMENICI. She said if you ever do that again, you know, she did not say what would happen, but probably something bad.

[Laughter.]

Senator DOMENICI. Just two or three questions: one, I need you to check on the budgetary impact of parity for the mentally ill statutorily as it applies to the insurance companies of America, group policies. Would you do that for me?

Mr. HOLTZ-EAKIN. Certainly.

Senator DOMENICI. I am saying that, looking at what you all have done in the past, I cannot understand why you estimate such a large budgetary impact, but I would like you to tell me that.

Mr. HOLTZ-EAKIN. Certainly.

Senator DOMENICI. This balance of trade accounts that Senator Sarbanes was going to talk about, how much of that is attributable to our having to purchase oil overseas?

Mr. HOLTZ-EAKIN. I do not know the number off the top of my head, but oil imports are a substantial part of the net trade situation.

Senator DOMENICI. Would you get the number and——

Mr. HOLTZ-EAKIN. Yes.

Senator DOMENICI [continuing]. The percent and submit it to the Chairman? Maybe somebody there knows.

Mr. HOLTZ-EAKIN. It is about $180 billion. We have a $600 billion—so it is not quite a third.

Senator DOMENICI. Not quite a third.

Mr. HOLTZ-EAKIN. Of the deficit.

Senator DOMENICI. So that is a very large amount that would be dramatically reduced if we did not have to buy oil overseas, right?

Mr. HOLTZ-EAKIN. Other things equal, yes.

Senator DOMENICI. That is arithmetic.

Mr. HOLTZ-EAKIN. That arithmetic, yes.

Senator DOMENICI. In your opinion, how risky is it that the Chinese are buying a significant portion of our debt, the Chinese, the Japanese——

Mr. HOLTZ-EAKIN. There are two levels to the question. One is purely economic, and it is not our central forecast that it is a problem; it is certainly a risk that there may be a shift in the desire of foreign investors to hold U.S. securities and, in particular, U.S. Treasuries. So it is a concern. We are looking at it.

And the second is whether it is past economics and that there would be more strategic motives involved in foreign governments' purchases or sales, and on that, we are really not qualified to say, but it is something we watch, and it is out there.

Senator DOMENICI. But the point of it is that there are not very many places they can put their money that is as secure as ours.

Mr. HOLTZ-EAKIN. No, it is unlikely we are going to see a big problem, because the U.S. remains a good investment environment; it remains, you know, a reserve currency. At the moment, a fraction of U.S. international liabilities, whether in total or Government, held by foreign governments is smaller than it was 10 years ago, smaller than it was 20 years ago, but it is certainly something that merits watching, and we do so with each forecast.

Senator DOMENICI. My last question has to do with immigration. The fact that we, as the Chairman said, we do not have as many people working per Social Security recipient is part of the big, overall problem, but we also need an economy that needs more workers. You cannot just say we need more immigration; we need more immigration if the American economy can assimilate more employees.

Is that an automatic thing, or is that related to the growth in the American economy and how we are doing versus competition in the world?

Mr. HOLTZ-EAKIN. The benefits of immigration are broadly the same as the benefits of being open in trade in goods, capital and also in skills and labor. The flows of immigration are determined by our performance economically and performance elsewhere in the globe and also on the policies toward immigration. I mean, there are clearly important considerations that go into this. So it is a broad, you know, set of influences.

Senator DOMENICI. Thank you very much, Mr. Chairman.

Chairman GREGG. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Mr. Holtz-Eakin, I do not know if you had a chance to read the New York Times this morning.

Mr. HOLTZ-EAKIN. I did.

Senator CONRAD. There was an opinion piece by Mr. Krugman, noted economist, talking about the growth of the economy over the last 75 years compared with your projections of the growth of the economy over the next 75 years and this question of Social Security solvency. He makes an interesting observation that the growth has been, over the last 75 years, 3.4 percent. You told us this morning you are projecting growth over the next 75 years of 1.8 percent.

His point is that if we are going to have that kind of slowdown in economic growth, how can we expect the same rate of equity growth that we experienced over the previous period? Did you have the chance to read that?

Mr. HOLTZ-EAKIN. I will not pretend to have studied it in any great detail. I think that there are, you know, two issues raised by it that I saw right away. The first is whether it is possible to have a rate of return on corporate equities in real terms, inflation-adjusted of, say, 6.8 percent, our assumption, that is above the long-term growth rate of the economy. And the answer to that, I think, has to be yes, because historically, it has happened. We have seen the 6.8 percent happen as a matter of history. As you note, his article says that the economy grew much slower than that in total.

The second issue is whether——

Senator CONRAD. Can I just stop you on that?

Mr. HOLTZ-EAKIN. Yes; that is just the facts.

Senator CONRAD. Let me just stop you on that point, because if we had a growth of 6.5 or 6.8 percent in stocks over the previous period——

Mr. HOLTZ-EAKIN. Rate of return.

Senator CONRAD. A rate of return, but that was in an environment in which the economy was growing 3.4 percent——

Mr. HOLTZ-EAKIN. Yes.

Senator CONRAD [continuing]. Would it not be fair to assume that if economic growth slowed to 1.8 percent, that equity rate of return might also slow?

Mr. HOLTZ-EAKIN. The second point is what would be the future in the face of faster or slower economic growth, either as a matter of other stuff, like immigration, or policies, and there, you would want to look and see the extent to which national saving changed and the things that would determine long-run economic growth were going to alter future rates of return. That is certainly part of a comprehensive assessment of the future of Social Security.

Senator CONRAD. Well I had never thought of this point, frankly, but it raises an interesting question about how our equity growth is tied to economic growth? Is there a relationship? I assume there is. If we are going to have slower economic growth than we have had over the previous 75 years, does that mean we should expect slower equity growth? And how does that affect all of our calculations?

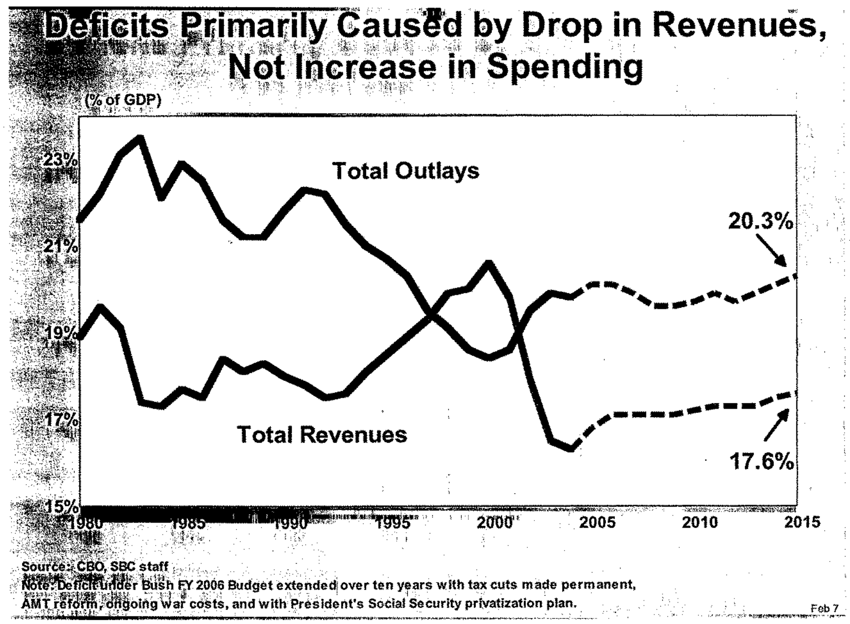
And it goes back to the question of the economic growth that you project over the next 75 years. Are there things that we could do that would get stronger economic growth? What would be the factors that would contribute to stronger economic growth in terms of Government policy?

Mr. HOLTZ-EAKIN. Economists organize the sources of growth into nice little bundles, and the bundles are accumulation of capital, a term that encompasses all of the things that you do when you do not eat something today, and you save it for tomorrow, you put it into——

Senator CONRAD. That has to do with savings.

Mr. HOLTZ-EAKIN. So any policy toward savings. Then, the labor inputs, the number of bodies, how many people are around to work, what skills they bring to work: education, training, those kinds of policies are there. The third bundle is technology, and the technologies are driven by policies toward R&D, intellectual property rights, all the incentives to innovate and claim the returns to that innovation. And then, there is the rest, which is the large unexplained portion that comes from managerial efficiencies and smarter ways of doing business.

Senator CONRAD. All right; Senator Enzi, and I am sorry that he is not still here, talked about how we got back on fiscal track before, and basically, he suggested it was all on the revenue side. I do not agree with that, and I do not think the facts show that. This shows, going back to 1980, the relationship between spending, that is the red line, and the green line, which is revenue. This is all as a share of gross domestic product, so we are using the measure which you said was most appropriate.



Deficits Primarily Caused by Drop in Revenues, Not Increase in Spending
(% of GDP)
23%
21%
19%
17%
15%
Total Outlays
20.3%
Total Revenues
17.6%
1980
1985
1990
1995
2000
2005
2010
2015
Source: CBO, SBC staff
Note: Deficit under Bush FY 2006 Budget extended over ten years with tax cuts made permanent, AMT reform, ongoing war costs, and with President's Social Security privatization plan.
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And what we see is, in fact, outlays did come down markedly during the 1990's. Outlays came down markedly. Revenue went up markedly during the nineties as a percentage of GDP. That is what produced budget surpluses. It was a combination of spending restraint and increased revenue, partly as a result of tax increases; partly as a result of strong economic growth.

Now, we can see what has happened to take us back into deficit. We have had a tick up in spending, although spending is still far below where it was in the eighties; the tick up is almost entirely homeland security and national defense. Ninety-one percent of the increase is just in those two categories. But the revenue has fallen out on us. We have the lowest revenue last year since the late 1950's.

So just as a factual matter, this is what I believe the facts are. This is what occurred. This is what occurred in terms of bringing down expenditures as a share of our national income, raising revenue as a share of our national income, and it shows us where we are now. It tells me that if we are going to solve this problem, we have to work both sides of the equation. We have to work the spending side of the equation and the revenue side.

I thank you.

Chairman GREGG. Thank you.

Senator ALLARD.

Senator ALLARD. Thank you, Mr. Chairman.

I come from a State where we do a lot of dynamic scoring in our budgeting process, and I want to make sure that I understand to what extent you use dynamic scoring with the CBO. And my understanding is that what might be referred to as dynamic, in quotes, that you actually take behavioral changes into effect, but that everything else is pretty much statics, particularly as it applies to the macroeconomic feedback effects.

Has the Congressional Budget Office studied ways to account for the macroeconomic feedback effects in its budget estimates?

Mr. HOLTZ-EAKIN. Why do I not tell you how we put these numbers together that you saw today, and you can decide what labels are appropriate.

A baseline projection takes into account current law and the economic incentives provided by current law. In particular, in this baseline projection, we have the difficult problem of assessing what happens in 2009, when dividend and capital gains rates go up; what happens in 2011, when marginal tax rates go up and all the provisions in EGTRRA and JGTRRA sunset.

We build into not just the evolution of taxable incomes but the macroeconomic performance feedbacks from that current law, from that current law. The hard part is actual economic performance depends on what people expect, and we do not know what the private sector expects about the permanence of the current tax rates.

So we take, as a matter of internal consistency, the assumption that people believe current law will execute as written: that the rates will go up in 2009 and 2011. We build that into our macro and our micro behavior. And whether that is fully dynamic or not, I do not know, but that is how the budget projections are done.

Senator ALLARD. So the CBO has moved—you are saying that the CBO has moved more toward, historically here in the last dec-

ade, has moved more toward using dynamic scoring, but as it applies to the macroeconomic effects, your policy has stayed pretty much the same.

Mr. HOLTZ-EAKIN. Baseline projections have always tried to incorporate whatever the fiscal policies are, and so, that, I believe, is a virtue, because it is the right way to do it, and it has always been done that way, to my knowledge. The biggest change has been in analyzing the President's budget, where we have, at the request of the budget committees, done an analysis that includes the macroeconomic impacts of the President's budgetary proposals.

Senator ALLARD. Yes.

Mr. HOLTZ-EAKIN. We have done that for 2 years now, and we hope that it is useful to the Committee.

Senator ALLARD. OK; so you are doing that now, where you had not done it in the past.

Mr. HOLTZ-EAKIN. Yes.

Senator ALLARD. And you plan on continuing to do more of that in the future?

Mr. HOLTZ-EAKIN. Absolutely; we would provide anything the Budget Committee would find useful in doing that analysis.

Senator ALLARD. It is kind of interesting to look at how States, and I want to talk a little bit about Medicaid here, that States will allocate in order to make up their share of the Medicaid, will take and overallocate the amount of dollars they send to their hospitals, and they get that rebated at the end, and the net effect is that probably, they have overleveraged Federal dollars. Would you comment on that problem some?

Mr. HOLTZ-EAKIN. We are unsure of the magnitude of these intergovernmental transfers and how they are affecting the Feds' share going to the States. We know that CMS is looking at them; that this is an important issue, and we are working with them and trying to learn from their investigations to see how many dollars are on the table. We are really not sure at the moment.

Senator ALLARD. So you cannot give us an estimate of how many States might be doing this?

Mr. HOLTZ-EAKIN. We do not know at the moment. It is something that we are looking at now.

Senator ALLARD. That would be a part of your investigation at the time?

Mr. HOLTZ-EAKIN. Yes.

Senator ALLARD. Thank you.

Chairman GREGG. Senator Sarbanes.

Senator SARBANES. Thank you very much, Mr. Chairman.

As recently as the 1980's, the U.S. was a creditor nation. U.S. investment abroad exceeded foreign-owned assets here by more than 10 percent of GDP. In today's economy, if that were still the case, it would be $1 trillion in a positive position. Regrettably, today, the U.S. is the world's, largest debtor. Our external debt in 2003 was $2.4 trillion, or nearly a quarter of our GDP, and we continue to run enormous trade and current account deficits. They are projected to be over $600 billion in 2004, which would mean that our external debt would then be over $3 trillion.

Just a few weeks ago, the President of the Federal Reserve Bank of New York, Timothy Geithner, noted in a speech: the size and

concentration of external imbalances in the system are at an unprecedented scale, between 5 to 6 percent of GDP in the case of the U.S. current account deficit. The counterpart of this deficit is a large inflow of capital from elsewhere in the world. The expected trajectory for this imbalance produces a dramatic deterioration in our net international position and cannot be sustained indefinitely. And Geithner concluded: what is new is that we are significantly more dependent today on the confidence of the rest of the world in U.S. economic policy and the safety and stability of our financial markets.

And the Financial Times, in an editorial earlier in the year, said: like Tennessee Williams' ill-fated character, Blanche DuBois, the United States has long been dependent on the kindness of strangers. And that is the issue I want to examine with you here this morning.

Now, first of all, given some questions that were asked, which of our trading partners hold substantial dollar reserves, in other words, have these claims against the U.S.?

Mr. HOLTZ-EAKIN. The largest outstanding are Japan, in most recent years, the largest increase has been in China.

Senator SARBANES. And then, would Korea and Taiwan come in behind them?

Mr. HOLTZ-EAKIN. I could check. I think that is right.

Senator SARBANES. Do we import oil from any of those countries?

Mr. HOLTZ-EAKIN. I do not know.

Senator SARBANES. I do not think so.

Mr. HOLTZ-EAKIN. If I say no, I am probably wrong, but I do not think they are substantial.

Senator SARBANES. Well, I do not think so, just to clear that off the deck.

Now, you say in your report, the trade deficit has widened by an estimated $230 billion in nominal terms or about 2 percent of GDP, but then, you say you expect a decline or a reverse in the near future, and by 2006, the growth of exports is likely to outpace that of imports.

Now, OECD projects that for 2005, the trade imbalance is going to go up to about $700 billion negative, and you are saying that by 2006, namely, in the next year, that the growth of exports will outpace that of imports. It is a shift in the trajectory; is that what you are telling me?

Mr. HOLTZ-EAKIN. Broadly; what we have underneath our projections is an improvement eventually in the U.S. current account position.

Senator SARBANES. Yes, but I want to know how fast. What are you projecting for 1906?

Mr. HOLTZ-EAKIN. We expect a turnaround after 2 years.

Senator SARBANES. In other words, then, instead of being $700 billion, it will be $675 billion or some figure like that; is that what you are telling me?

Mr. HOLTZ-EAKIN. I do not know what the number is for 1905, but what we expect is for 1905, it will continue to worsen; 1906, we will begin to see a turn. That is the mechanics of the projection.

Senator SARBANES. When are you projecting that we will be back in balance?

Mr. HOLTZ-EAKIN. I do not think we have a projection of that.

Senator SARBANES. You cannot glimpse it on the horizon, can you?

Mr. HOLTZ-EAKIN. No.

Senator SARBANES. No; now, even in this projection you are making, the projected trend in the trade balance largely reflects the expected decline of the dollar relative to the currencies of the U.S. trading partners, especially those of Asian economies. What makes you think that is going to happen? What has happened in the depreciation of the dollar over the past 3 years has been relative to the euro and other non-Asian currencies, has it not?

Mr. HOLTZ-EAKIN. The trade-weighted dollar has depreciated in nominal terms, and that is the core of both the history and our projection, and the questions then become how quickly does that change prices of imports relative to exports?

Senator SARBANES. How is it going to change if the Chinese are pegging the value of their currency? John Snow tells them, they should go to flexible rates. Now, they are not going to go to flexible rates. Everybody knows that, because it invites a banking crisis in China, at least that is what everyone tells us. And Snow has not asked them to repeg, so if they stay at the peg, how are you going to correct the Chinese imbalance?

Chairman GREGG. Senator, we are going to have to move on here, but we are going to have Secretary Snow here next week, and that is a good question for him.

Senator SARBANES. Yes, but this guy is pretty good.

[Laughter.]

Chairman GREGG. Well, why do you not go ahead and answer his question, Mr. Director?

Mr. HOLTZ-EAKIN. I am flattered.

Senator SARBANES. What I meant by that is I regard you as a straight shooter and not a spin artist. I think that is important.

Mr. HOLTZ-EAKIN. The Chinese peg, let us just assume it stays. China is not our only trading partner, and the current account is the net effect of all trade transactions with all of our trading partners. So our forecast does not assume that the Chinese change their peg a bit. It assumes that relative to all of our trading partners, the dollar does, in fact, continue to decline somewhat.

But that is not the only mechanism by which the current account reverses. To some extent, we count on oil prices moderating a touch. It is the case that world economic growth has been very slow relative to the U.S., and part of the forecast, both for the United States and more generally is for world economic growth to improve. So that will help.

Senator SARBANES. No, I want to go specifically on what you said in the report.

Chairman GREGG. Could we move on, and——

Senator SARBANES. Could I just ask this one question?

Chairman GREGG. OK.

Mr. HOLTZ-EAKIN. I hope we said that in the report. I believe——

Senator SARBANES. Let me quote from the report: "The projected improving trend in the trade balance largely reflects the expected decline of the dollar relative to the currencies of the United States' trading partners, especially those of Asian economies." How do you

expect there to be a decline of the dollar—let me be very specific—relative to the currency of China, if they continue to do the peg?

Mr. HOLTZ-EAKIN. Again, we do not have a projection that relies on bilateral exchange rates with particular countries. It is the broad trade-weighted one, and we can do it by Asian or non-Asian countries, if you would like. We would be happy to work with you on this.

Senator SARBANES. Well, that is not what this statement says.

Chairman GREGG. Senator Bunning.

Senator BUNNING. I am the last one here, I guess. Thank you, Mr. Chairman.

You know, I once heard that budget forecasting was referred to as being about as accurate as forecasting earthquakes. As an economist, could you please comment on the historical accuracy of long-term projections of the Federal budget deficit by CBO, by OMB, by others who might get into the forecasting business?

Mr. HOLTZ-EAKIN. We can not only comment on it; we try to display it in the report. We show the uncertainty around our baseline projections in a fan chart. The fan chart tells you, for example, that under the baseline, take all its flaws at the moment, but under the baseline, the deficit is 1.2 percent of GDP 5 years from now. Based on historical uncertainty in the economic performance and in technical relationships between the budget and the economy, there is a 5 percent chance that that number could be 6 percent of GDP or greater. There is a 35 percent chance that it could be in balance or better.

Senator BUNNING. OK.

Mr. HOLTZ-EAKIN. There is an enormous range of uncertainty that should be acknowledged and should be used in evaluating policies.

Senator BUNNING. If you have a $2.5 trillion economy, and you are off by 5 percent, what is that in dollars?

Mr. HOLTZ-EAKIN. We have a $2.5 trillion budget; 10 percent of that is $250 billion; 5 percent is $125 billion.

Senator BUNNING. $250 billion——

Mr. HOLTZ-EAKIN. Five percent would be $125 billion; no, that is not right.

Senator BUNNING. Uh-oh.

Mr. HOLTZ-EAKIN. Of the budget, yes.

Senator BUNNING. OK; and I wanted to get to what Senator Sarbanes has been talking about, because we would like for you, Senator Sarbanes, to join Senator Schumer and myself in trying to get China to unpeg their currency from the dollar. We have a bill in to do just that. Would you like to comment on the impact, if any, the weak dollar has had both on the assumptions behind your analysis and the conclusions of your report?

Mr. HOLTZ-EAKIN. The dollar narrowly, the international situation more broadly, are all part of the forecast for the U.S. economy in terms of its cyclical recovery, where we anticipate better net export performance over the next 2 years, and as a result, they feed into the budgetary outlook. And so, it is the case that the budget projections and the economic projections are an internally consistent whole, and the economic projections in particular add up.

We take into account international conditions and domestic conditions and make sure that it is an internally consistent forecast.

So we are, in fact, cognizant of the dollar and the future path of the dollar as part of our forecast.

Senator BUNNING. Has CBO always done that? I mean, have they used that projection in their past? I have been on budget committees for 8 years, both the House and the Senate Budget Committee, and it seems to me that the accuracy in forecasting the deficits, the surpluses, the growth in the economy, the growth in the CPI, have been so skewed by CBO over the last 8 years that I have been on budget committees that it has just been unbelievable to try to get a handle on the current budget. Is that an incorrect assumption?

Mr. HOLTZ-EAKIN. I think that CBO's forecasts of the budget and of the economy are comparable in quality to anyone. You and I could have a discussion about whether the economics profession as a whole has progressed to the point where they provide forecasts that you are happy with, but the CBO projections are of equally high quality to those of the OMB, the private sector, and many.

Senator BUNNING. Is it true that if I brought 10 economists in here, not one of them would have the same projection given the same numbers?

Mr. HOLTZ-EAKIN. It would be true that it would be unlikely that you would get exactly the same projections, but given the range of movements, I think our projection is qualitatively very similar to the blue chip consensus, for example. It is in the report, the comparisons, and other forecasters.

We do display on our Website our forecasting record. You can go check for yourself. And we are always looking to improve it. We are cognizant of the gap between what happens in fact and what we project, and everywhere we can close that gap, we have attempted to do so over the years.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman GREGG. Thank you. You have been courteous with your time, Mr. Director. I know Senator Sarbanes had just a couple of followup questions.

Mr. HOLTZ-EAKIN. Sure.

Chairman GREGG. And then, we will give you a break.

Senator SARBANES. Well, thank you very much, Mr. Chairman. I know this hearing has been going on for quite some time, and you wish to draw it to a close.

I just have a couple of questions I want to pursue. Do you regard the dollar being the world's reserve currency as an important economic or financial factor or asset for the United States?

Mr. HOLTZ-EAKIN. It represents another source of demand for dollars and dollar-denominated assets and fits in the constellation of reasons why you would not expect a precipitous shift away in international portfolios. So it is one feature.

Senator SARBANES. Do you think that the U.S. would have lost something of import and value if the dollar ceased to be the world's reserve currency?

Mr. HOLTZ-EAKIN. Again, other things equal, if people have less of a standing desire to hold dollars in their portfolios and do so strictly on other considerations, risk, return and the others, then,

that represents a diminished appetite for dollar-denominated assets.

Senator SARBANES. What are the implications of that for us?

Mr. HOLTZ-EAKIN. Qualitatively, I think more sensitivity in dollar demand, in the demand for dollar-denominated assets to prices, but I do not know numerically how large that would be.

Senator SARBANES. The Financial Times a week ago yesterday said "central banks are shifting reserves away from U.S. assets and toward the euro zone in a move that looks set to deepen the Bush administration's difficulties in financing its ballooning current account deficit. In actions likely undermine the dollar's value on currency markets, seventy percent of central bank reserve managers said they had increased their exposure to the euro over the past 2 years. The majority thought euro zone money and debt markets were as attractive a destination for investment as the United States."

That has serious implications for us, does it not?

Mr. HOLTZ-EAKIN. As the Senator knows, the current account reflects the desire to make capital investments, both in a portfolio and in actual factories in the United States, and to the extent that that desire diminishes, it will have negative implications as to financing.

Senator SARBANES. Some of that is not investment. Some of that is buying our Treasuries, in order to impact the value of the currency to gain a trade advantage. Otherwise, why are the central banks of China and Japan building up such large dollar reserves?

Mr. HOLTZ-EAKIN. There is no question that central banks intervene to manage currencies.

Senator SARBANES. To manage currencies.

Mr. HOLTZ-EAKIN. To manage currencies, no question.

Senator SARBANES. And that is clearly going on.

Mr. HOLTZ-EAKIN. And that is part of the overall determination.

Senator SARBANES. Mr. Chairman, I think this is an important issue. I am just trying to help the President out. He seems to be searching around for a crisis on which to focus his attention, and I want to suggest and will continue to suggest that, between the internal deficit, which Senator Conrad talked about, and this external situation, we have a crisis at hand.

Thank you very much.

Chairman GREGG. I appreciate your thoughts, Senator, and we certainly thank the Director for his courtesy and the time he has granted us this morning, and we look forward to continuing to work with him and his excellent staff, who do such a good job for us.

Thank you very much.

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman.

[The prepared statement of Mr. Holtz-Eakin follows:]

# CBO TESTIMONY

Statement of
Douglas Holtz-Eakin
Director

## The Budget and Economic Outlook: Fiscal Years 2006 to 2015

before the
Committee on the Budget
United States Senate

February 1, 2005

*This document is embargoed until 10 a.m. (EST), Tuesday, February 1, 2005. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.*

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Chairman Gregg, Senator Conrad, and Members of the Committee, I am pleased to be here today to discuss the Congressional Budget Office's (CBO's) report *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*.

CBO projects that if current laws and policies remained the same, the federal government would run budget deficits of $368 billion in 2005 and $295 billion in 2006 (see Table 1). However, because of the statutory rules that govern such baseline projections, those estimates omit a significant amount of spending that will occur this year—and conceivably for some time in the future—for U.S. military operations in Iraq and Afghanistan and for other efforts in the war on terrorism.

Additional appropriations for such purposes are expected to add about $30 billion to the deficit this year and possibly more next year. Thus, the 2005 deficit is likely to total around $400 billion and the 2006 deficit well over $300 billion. With that extra spending included, the deficit in 2005 would amount to about 3.3 percent of gross domestic product (GDP)—compared with last year's deficit of 3.6 percent of GDP.

The absence of further appropriations for activities in Iraq and Afghanistan also masks a deterioration in budget projections over the 10 years in CBO's baseline. Since September 2004, when CBO last made projections,[1] the cumulative deficit projected for the 2005-2014 period (the 10 years covered by the previous baseline) has declined from $2.3 trillion to $1.4 trillion. However, following rules set forth in law, CBO's September baseline extrapolated supplemental funding for 2004—provided mostly for activities in Iraq and Afghanistan—throughout the 10-year period, thereby increasing projected outlays by more than $1.4 trillion (including the additional interest payments on federal debt). CBO's current baseline does not include appropriations for those activities because the funds have not been provided yet this year. If the baselines are made comparable by removing that extrapolation of supplemental funding from the preceding baseline, the outlook has actually become less favorable: the total deficit projected for the 2005-2014 period has grown by more than $500 billion, or 0.3 percent of GDP (see Table 2). New legislation accounts for about three-quarters of that increase, most of it from recent laws that extend certain tax provisions and provide funding for disaster relief.

By statute, CBO's baseline projections must estimate the future paths of federal spending and revenues under current laws and policies. The baseline is therefore not intended to be a prediction of future budgetary outcomes; instead, it is meant to serve as a neutral benchmark that lawmakers can use to measure the effects of proposed changes to spending and taxes.

Underlying CBO's baseline projections is a forecast that the U.S. economy will continue to grow at a healthy pace in 2005 and 2006. Although real (inflation-adjusted) GDP grew rapidly during the past two years, output remained considerably below the economy's potential. Therefore, by CBO's expectations, GDP will grow at an average annual rate of about 3.8 percent in the next two years to close most of that gap, before slowing to a pace of 2.9 percent for the 2007-2015 period.

Over the longer term, the federal budget will be strained significantly by demographic changes that will begin within the current 10-year projection period and intensify as members of the baby-boom generation age. In particular, the rising cost of health care will contribute to the growth of programs for elderly and low-income beneficiaries. As a result, under current law, total federal spending for Social Security, Medicare, and Medicaid

1. See Congressional Budget Office, *The Budget and Economic Outlook: An Update* (September 2004).

**Table 1.**

## CBO's Baseline Budget Outlook

| | Actual 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | Total, 2006-2010 | Total, 2006-2015 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | In Billions of Dollars | | | | | | | |
| Total Revenues | 1,880 | 2,057 | 2,212 | 2,357 | 2,508 | 2,662 | 2,806 | 3,062 | 3,303 | 3,474 | 3,657 | 3,847 | 12,545 | 29,888 |
| Total Outlays | 2,292 | 2,425 | 2,507 | 2,618 | 2,743 | 2,869 | 2,996 | 3,142 | 3,232 | 3,389 | 3,542 | 3,706 | 13,733 | 30,743 |
| **Total Deficit (-) or Surplus** | -412 | -368 | -295 | -261 | -235 | -207 | -189 | -80 | 71 | 85 | 115 | 141 | -1,188 | -855 |
| On-budget | -567 | -541 | -484 | -471 | -464 | -453 | -451 | -357 | -217 | -212 | -190 | -169 | -2,323 | -3,469 |
| Off-budget[a] | 155 | 173 | 190 | 210 | 229 | 246 | 262 | 277 | 288 | 298 | 305 | 310 | 1,136 | 2,614 |
| Debt Held by the Public at the End of the Year | 4,296 | 4,665 | 4,971 | 5,246 | 5,494 | 5,716 | 5,919 | 6,012 | 5,955 | 5,884 | 5,784 | 5,658 | n.a. | n.a. |
| | | | | | | | As a Percentage of GDP | | | | | | | |
| Total Revenues | 16.3 | 16.8 | 17.2 | 17.3 | 17.5 | 17.7 | 17.8 | 18.6 | 19.2 | 19.3 | 19.4 | 19.6 | 17.5 | 18.5 |
| Total Outlays | 19.8 | 19.8 | 19.5 | 19.3 | 19.2 | 19.1 | 19.0 | 19.0 | 18.7 | 18.8 | 18.8 | 18.9 | 19.2 | 19.0 |
| **Total Deficit (-) or Surplus** | -3.6 | -3.0 | -2.3 | -1.9 | -1.6 | -1.4 | -1.2 | -0.5 | 0.4 | 0.5 | 0.6 | 0.7 | -1.7 | -0.5 |
| Debt Held by the Public at the End of the Year | 37.2 | 38.1 | 38.6 | 38.6 | 38.4 | 38.0 | 37.6 | 36.5 | 34.5 | 32.6 | 30.7 | 28.8 | n.a. | n.a. |
| **Memorandum:** | | | | | | | | | | | | | | |
| Gross Domestic Product (Billions of dollars) | 11,553 | 12,233 | 12,888 | 13,586 | 14,307 | 15,029 | 15,757 | 16,494 | 17,245 | 18,023 | 18,826 | 19,652 | 71,566 | 161,806 |

Source: Congressional Budget Office.

Note: n.a. = not applicable.

a. Off-budget surpluses comprise surpluses in the Social Security trust funds as well as the net cash flow of the Postal Service.

is projected to grow by about 25 percent over the next 10 years relative to the size of the economy—from 8.4 percent of GDP in 2004 to 10.4 percent of GDP in 2015.

After 2015, if the growth of health care costs continues to exceed that of the economy, outlays for Social Security, Medicare, and Medicaid will claim an even larger share of federal spending as the percentage of the population age 65 or older continues to rise (from 14 percent in 2015 to 19 percent in 2030). Thus, over the long term, the increasing resources needed for such programs will exert pressure on the federal budget that will make current fiscal policy unsustainable.

## The Budget Outlook

Under the assumption that current laws and policies remain unchanged, CBO projects that federal deficits will begin to decline this year. In CBO's baseline, deficits drop as a percentage of GDP, from the 3.6 percent recorded in 2004 to 1.2 percent in 2010. Beginning in 2012—if taxes increased as scheduled under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), discretionary spending continued to

**Table 2.**

## Changes Since September 2004 in CBO's Estimate of the Cumulative Deficit for 2005 to 2014

(Billions of dollars)

| | 10-Year Total |
|---|---|
| September 2004 | |
| Projected deficit | -2,294 |
| Less the effect of extending supplemental appropriations for 2004 | 1,433 |
| Adjusted projected deficit | -861 |
| Other Changes to the Baseline Since September 2004 | |
| Legislative | -371 |
| Economic | 41 |
| Technical | -173 |
| Total | -504 |
| January 2005 | |
| Projected deficit | -1,364 |

Source: Congressional Budget Office.

Note: According to rules set forth in law, CBO's September 2004 baseline extrapolated through 2014 supplemental appropriations of $115 billion provided in 2004 (mostly for operations in Iraq and Afghanistan). CBO's January 2005 baseline does not include appropriations for those operations because the funds have not been provided yet this year. Hence, for the purpose of making a consistent comparison between the September 2004 and January 2005 baselines, this table removes the extension of such supplemental appropriations from the previous baseline. The 10-year totals include changes in projected debt-service costs (interest payments on federal debt) resulting from projected changes in the government's borrowing.

Negative numbers in this table represent deficits or increases to deficits.

In the current baseline, which covers 2006 through 2015, the cumulative deficit totals $855 billion.

grow no faster than inflation, and other policies stayed the same—the budget would shift to small annual surpluses.

Over the 2005-2015 period, outlays are projected to grow at an average annual rate of 4.3 percent and to gradually diminish from 19.8 percent of GDP this year to 18.9 percent in 2015 (see Figure 1). That downward drift of total outlays as a percentage of GDP is driven by the treatment of discretionary spending under rules set forth in law. CBO projects growth in discretionary spending as specified in the Balanced Budget and Emergency Deficit Control Act of 1985 (using the GDP deflator and the employment cost index for wages and salaries). The combined rate of growth of those factors is about half of that projected for nominal GDP. As a result, CBO's baseline projection for discretionary outlays falls from 7.6 percent of GDP in 2005 to 5.6 percent in 2015. Including future costs for activities in Iraq and Afghanistan (and for other such activities) would probably not affect that trend significantly.

Mandatory spending continues to account for a rising share of federal outlays; such spending is projected to grow from 54 percent of total outlays in 2004 to 62 percent in 2015 (see Figure 2). Under the assumption that no changes in policy take place, spending for mandatory programs is projected to grow by 5.7 percent a year—faster than the rate projected for the economy as a whole. Such growth is driven largely by outlays for Medicare and Medicaid, which are projected to rise at average annual rates of 9.0 percent and 7.8 percent, respectively, through 2015. By the middle of the projection period, Social Security spending is also expected to grow faster than the economy, as the baby-boom generation begins to collect benefits.

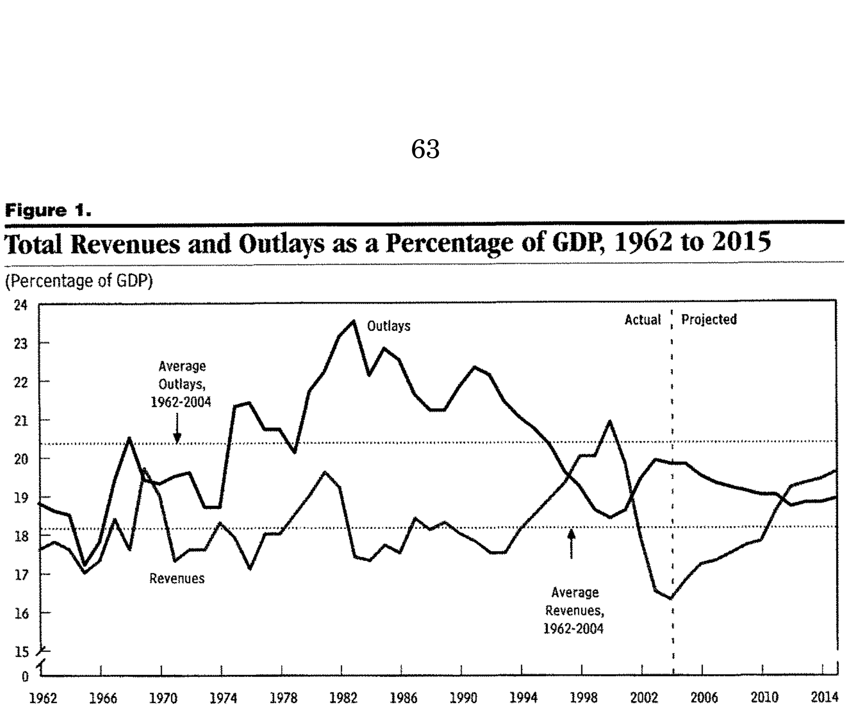
Revenues are projected to total 16.8 percent of GDP this year—nearly 1.5 percentage points below the average since 1962 (18.2 percent). Over the coming decade, revenues are expected to continue increasing, growing faster than GDP in every year of the projection period. That ascent is driven by the structure of the tax system, which causes revenues to claim a higher fraction of income in taxes every year as income grows. In addition, a large boost in revenues occurs in CBO's baseline after the major provisions of EGTRRA expire at the end of 2010. By 2015, such receipts are projected to reach 19.6 percent of GDP.

Debt held by the public (the most meaningful measure of federal debt in terms of its relationship to the economy) is anticipated to equal 38.1 percent of GDP at the end of this fiscal year. In CBO's baseline, that debt stabilizes at around its current level of GDP through 2010, at which point the federal government's diminished need to borrow reduces the growth of such debt.

Since September, when CBO issued its previous baseline, changes unrelated to the treatment of spending for activities in Iraq and Afghanistan have increased the cumulative deficit projected for 2005 to 2014 by more than $500 billion. Among the legislation that contributed to that increase was the Working Families Tax Relief Act of 2004. That law extended several tax provisions, including the 10 percent tax bracket, relief from the marriage penalty, and the increase in the child tax credit—thereby adding $146 billion to the 10-year deficit (excluding debt-service costs). In addition, supplemental appropriations for 2005 provide $11.5 billion in disaster relief for hurricane victims; extrapolating that budget authority through 2014 (following rules for the baseline) adds $94 billion to discretionary spending. Revisions to the baseline caused by changes in CBO's economic forecast were fairly small, reducing the projected 10-year deficit by $41 billion. Other, so-called technical revisions to the baseline—mostly involving revenues—increased that cumulative deficit by $173 billion.

**Figure 1.**

## Total Revenues and Outlays as a Percentage of GDP, 1962 to 2015




Source: Congressional Budget Office.

## The Economic Outlook

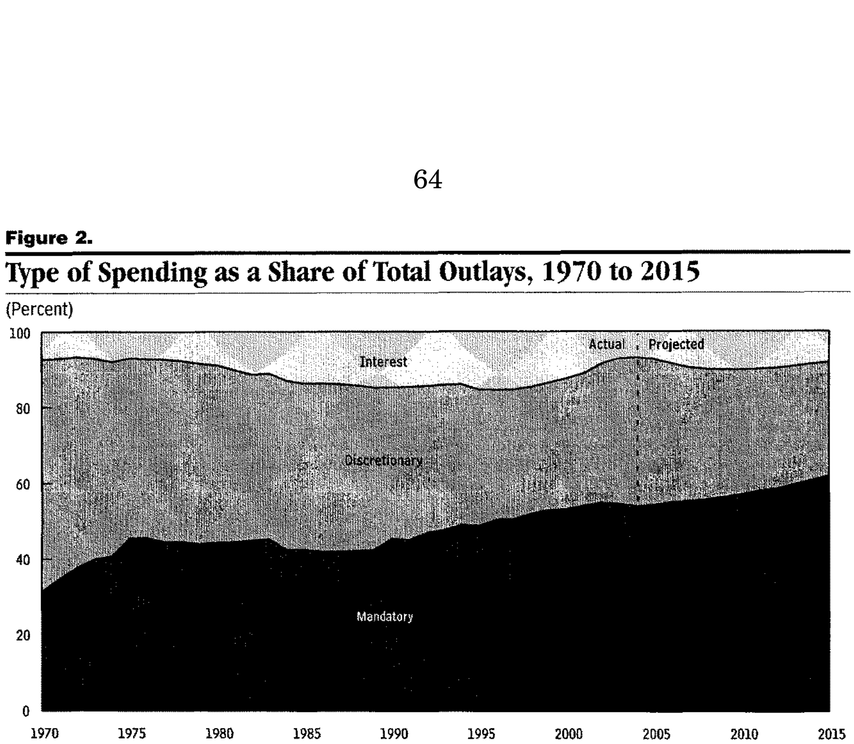
According to CBO's forecast, in 2005 and 2006, the U.S. economy continues to grow at a healthy pace. Although investment by businesses is not expected to grow as rapidly as in 2004, such spending will probably still lead the economy's continuing expansion. Moreover, the caution that has characterized firms' decisions over the past three years appears to be dissipating, and businesses seem to be having greater difficulty meeting increases in demand with their current workforce; as a result, hiring should accelerate. Growth of productivity, which has been exceptionally strong since 2001, is expected to slow relative to its rate in the recent past but to continue at a pace similar to the long-run average. Thus, CBO expects that real GDP will grow by 3.8 percent in calendar year 2005 and 3.7 percent in 2006, before slowing to a pace of 2.9 percent for the 2007-2015 period (see Table 3).

The rate of unemployment is forecast to decline from 5.4 percent at the end of 2004 to 5.2 percent in 2005 and 2006. During the 2007-2015 period, the rate of unemployment is expected to average 5.2 percent.

According to CBO's forecast, inflation is lower in 2005 and 2006 than in 2004. A surge in energy prices, along with an acceleration in the cost of shelter and in used car prices, caused a spike in inflation in 2004, as measured by the consumer price index for all urban consumers. That increase is not expected to feed into core inflation (inflation excluding changes in prices for food and energy). CBO projects that consumer prices will rise by 2.4 percent in 2005 and 1.9 percent in 2006; during the 2007-2015 period, CBO anticipates growth averaging 2.2 percent.

**Figure 2.**

# Type of Spending as a Share of Total Outlays, 1970 to 2015




Source: Congressional Budget Office.

Interest rates are expected to move upward during the next two years, as the economy grows and the Federal Reserve continues to move toward a more neutral monetary policy. CBO forecasts that the three-month Treasury bill rate will rise to about 2.8 percent in 2005 and 4 percent in 2006; thereafter, it will average 4.6 percent, which is relatively low by historical standards. In the forecast, the rise in the rate for the 10-year Treasury note is somewhat smaller; it averages 4.8 percent in 2005 and 5.4 percent in 2006, then inches up to average 5.5 percent from 2007 to 2015.

**Table 3.**

# CBO's Economic Projections for Calendar Years 2005 to 2015

| | Estimated | Forecast | | Projected Annual Average | |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007-2010 | 2011-2015 |
| Nominal GDP (Billions of dollars) | 11,730 | 12,396 | 13,059 | 15,940 [a] | 19,861 [b] |
| Nominal GDP (Percentage change) | 6.6 | 5.7 | 5.3 | 5.1 | 4.5 |
| Real GDP (Percentage change) | 4.4 | 3.8 | 3.7 | 3.3 | 2.7 |
| GDP Price Index (Percentage change) | 2.1 | 1.8 | 1.5 | 1.8 | 1.8 |
| Consumer Price Index[c] (Percentage change) | 2.7 | 2.4 | 1.9 | 2.2 | 2.2 |
| Unemployment Rate (Percent) | 5.5 | 5.2 | 5.2 | 5.2 | 5.2 |
| Three-Month Treasury Bill Rate (Percent) | 1.4 | 2.8 | 4.0 | 4.6 | 4.6 |
| Ten-Year Treasury Note Rate (Percent) | 4.3 | 4.8 | 5.4 | 5.5 | 5.5 |

Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis; Department of Labor, Bureau of Labor Statistics; Federal Reserve Board.

Note: Percentage changes are year over year.

a. Level in 2010.

b. Level in 2015.

c. The consumer price index for all urban consumers.

Chairman GREGG. The next hearing will be on February 8, and the Comptroller General is going to be participating.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

**STATEMENT OF SENATOR BUNNING**

**SENATE COMMITTEE ON THE BUDGET**

**CBO'S BUDGET AND ECONOMIC OUTLOOK**

Thank you, Mr. Chairman.

I was concerned, as I'm sure were most members of this committee, to read new CBO estimates of a $368 billion budget deficit for fiscal 2005.

This number brings into stark reality the magnitude of the job before us in this committee and in the Congress. Certaninly, we need to see spending reigned in.I11I was please with recent statments from the Administration regarding the President's commitment to control spending. We, as a country, have faced difficult challenges over the past few years and we will continue to face them. Protecting our citizens does not come cheap, but it must be our highest priority.

However, we must be disciplined in all areas of the budget we are about to produce in this committee. We must make difficult decisions and we must lead the Senate in sticking to them.

My review of the recent CBO report shows that freezing discretionary spending during the 10-year window would reduce the deficit by about $3 trillion compared to letting discretionary spending grow at the rate of GDP.

While a true freeze on discretionary spending may be difficult, we must at least work toward reigning in the rate of spending growth.

Additionally, and maybe even more importantly, we must examine mandatory spending. Our chairman has mad clear that he is willing to look at this often-ignored part of the budget and I support his plan to put these entitlement items on the table and examine them.

Congress must also take a hard look at our Social Security System and make some reforms. In only 13 years, Social Security will begin paying out more in benefits than it collects in revenue. By the year 2042, the program will be insolvent. Without any reforms, the current system has an unfunded liability of over ten trillion dolloars. We owe it to our children and grandchildren to have an honest debate on this issue and put this program on a financially sound path.

I thank Dr. Holtz-Eakin for the hard work and dedication of his office and for his willingness to appear before us today to explain the most recent analysis in detail.

Thank you.

Debbie Stabenow

Statement By
Senator Debbie Stabenow
Senate Budget Committee
February 1, 2005 (1/31 11:41 AM)

Mr. Chairman, thank you for holding this hearing and I wish you well as you take over the gavel for the first time on this Committee.

Unfortunately, once again, today we are reviewing America's budget and finding record red ink as far as the eye can see.

But we must remember that budgets are about more than just numbers. Our nation's budget reflects our values and priorities. Tragically, leaks about the Administration's budget show us that investments like education and veterans' health care will be cut and on top of that, we expect to get a request for another $80 billion for operations in Iraq. To put this $80 billion in perspective, it is more than we spend in one year on our veterans ($66 billion – Department of Veterans Affairs -FY05) and on our school children ($57 billion – Department of Education—FY05).

Mr. Chairman, our first challenge should be to get our fiscal house in order. However, instead of reducing the deficit, the Administration is seeking to scare seniors and all Americans about the status of Social Security. Social Security does face long term challenges, but it is not in crisis.

In fact, CBO reports that **Social Security can pay 100 percent of its commitments until the year 2052**. Even after that – nearly 50 years from now – the projected Social Security shortfall is only one-fifth, or 20 percent, the cost of the President Bush's tax breaks.

Mr. Chairman, Social Security is a great American success story. Before Social Security, 50 percent of older Americans were living in poverty. Now, only 10 percent are.

And it's about more than retirement. **Social Security is America's insurance policy and it is here for you right now.** Did you know that Social Security protects you whether you're a 22-year-old just starting your career or you're a 75-year-old enjoying retirement? It covers you if you lose a parent or if you become disabled.

Those advocating a risky privatization scheme are pushing much more than private accounts.

If you read the details of what many are proposing, you see that this risky privatization scheme will result in deep benefits cuts, even for those who do not

participate in private accounts – cuts as high as 25 percent for some current workers, and 45 percent for retirees in the future.

And this type of plan will add $2 trillion to our **national debt**. Because we already have a deficit, we will have to borrow all of the $2 trillion from other countries like China and Japan. Already our nation has the highest budget deficit in history. Further debt could destabilize financial markets, drive up interest rates, and stifle economic growth – forcing our children and grandchildren to pay for these financial burdens.

Mr. Chairman, now, more than ever, we need to fight to keep the security in Social Security.

And I hope this Committee will focus on returning to the fiscal discipline of the late 1990s instead of dismantling America's insurance policy.

Thank you.

Russ Feingold

Statement by Senator Russ Feingold
Senate Committee on the Budget
February 1, 2005

Mr. Chairman, first let me congratulate you on becoming the Chair of this Committee. I have had the pleasure of working with you on budget issues ever since we came to the Senate together in 1993. I have enjoyed serving with you on this committee, and I am delighted that you will be chairing it.

Today we will hear CBO's latest report on the budget and the economy. It should come as no surprise that the budget bottom line is bad, and that there is no sign that it is getting better.

As our colleagues know, CBO is strictly constrained in making its baseline estimates. It is unable to assume any policy action by Congress, no matter how reasonable that assumption might be. That means, for example, that the $80 billion in supplemental funding requested by the Administration for operations in Iraq and Afghanistan are not included in the baseline deficit projection for this fiscal year. Nor are the effects of making permanent all or a portion of the tax cuts set to expire in 2010.

These restrictions make sense at one level. It simply isn't possible for CBO to project policy changes with any kind of certainty. But while we may be making CBO's job a little more straightforward by not requiring them to include such projections, Congress certainly would ill serve taxpayers by ignoring them.

And the impact of the costly policy changes that are likely to be enacted over the next few years is significant.

Extending the expiring tax cuts adds $1.6 trillion to our debt beyond the CBO baseline. Reforming the Alternative Minimum Tax could add more than $600 billion to the CBO baseline. The supplemental appropriations bill requested by the President and the projected ongoing costs of the Iraq war over the next 10 years adds another $426 billion, while the President's defense policies might add more than $230 billion over that same period. With the additional debt service those policies would incur, we are looking at more than $4.2 trillion being added to our debt over the next 10 years.

Mr. Chairman, this is a much different picture than the one painted for us by CBO in January of 2001. At that time, the CBO baseline for the next 10 years projected surpluses of $5.6 trillion. Even with all the admitted shortcomings of a baseline projection, the deterioration in the bottom line since January of 2001 has been breathtaking.

There is no mystery about the causes of this change. Some of it was beyond our control,

due either to a slower economy or the spending done in response to the attacks of September 11. But the bulk cause of our budget deterioration was very much in our control, namely the irresponsible tax policies of the Administration.

When presented with an opportunity to reduce the debt burden of our children and grandchildren while also providing a meaningful and affordable tax cut for working families, the Administration, aided and abetted by Congress, instead chose an irresponsible, unbalanced tax cut which primarily benefitted those who are least in need of it while adding to the debt burden that will be borne by those who can least afford it.

Rather than staying the course we set in 1993, Congress and the White House instead embarked on fiscal policies that not only squandered all of the hard-earned progress we had made, but also ended up mortgaging the fiscal future of coming generations. And it all happened in the blink of a budgetary eye.

We have to stop running these debilitating deficits. They cause the government to use the surpluses of the Social Security Trust Fund for other government purposes, rather than to pay down the debt and help our nation prepare for the coming retirement of the Baby Boom generation. Every dollar that we add to the federal debt is another dollar that we are forcing our children to pay back in higher taxes or fewer government benefits. When the government in this generation chooses to spend on current consumption and to accumulate debt for our children's generation to pay, it does nothing less than rob our children of their own choices. We make our choices to spend on our wants, but we saddle them with debts that they must pay from their tax dollars and their hard work.

Mr. Chairman, this kind of budgeting is reckless. We absolutely must restore fiscal discipline, and central to that will be reimposing the budget rules that helped us eliminate the budget deficits of the early 1990s, and that eventually led to a balanced federal budget.

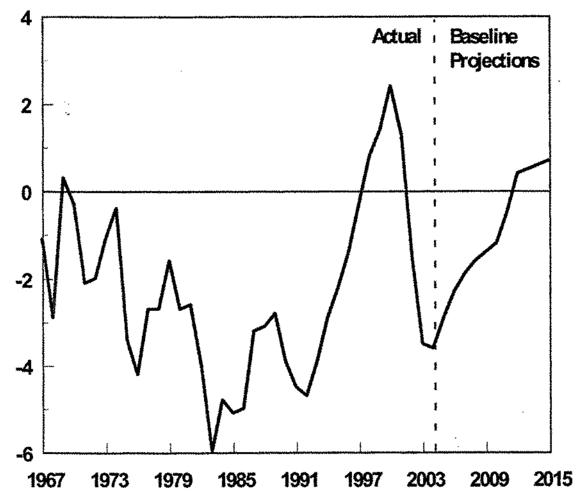
With this in mind, Mr. Chairman, I hope this committee will work to bring back a budget rule that was so essential in helping us balance the federal books, the PAYGO rule. Some may recall that I offered an amendment to last year's budget resolution to reinstate PAYGO. In fact, it was adopted in the Senate by a bipartisan majority, and I thank our Ranking Member, Senator Conrad, for his help with that amendment last year.

The Senate was most serious about restoring that particular budget discipline. I think we all know that the reason we did not get a budget resolution last year was the refusal of the House Leadership to accept that sensible budget rule, despite clear support for it in the other body. There are other budget process reforms that I support, but reinstating

PAYGO should be our highest priority. Without tough budget rules to hold policy makers' feet to the fire, there is little hope that the White House and Congress will ever make the tough decisions needed to eliminate the deficit.

I thank the Chairman and Ranking Member for their past efforts in this area, and I look forward to working with them this year to bring back the budget discipline that served us so well during the 1990s.

## The Total Deficit or Surplus as a Share of GDP, 1967 to 2015

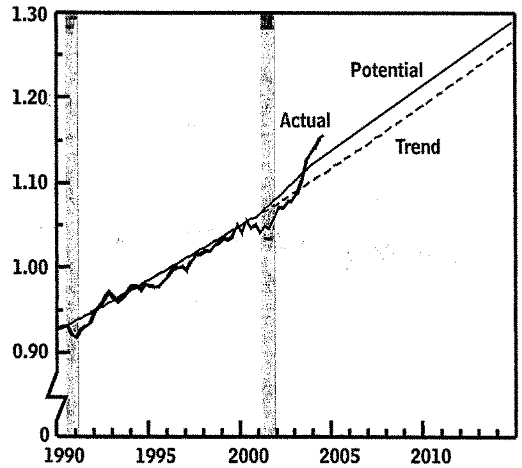


Testimony inserts in response to Questions from Mr. Crapo

## Comparison of CBO's January 2005 and September 2004 Baselines (Billions of dollars)

| Baseline | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Total, 2005-2014 |
|---|---|---|---|---|---|---|---|
| January 2005 | -368 | -295 | -261 | -235 | -207 | -189 | -1,364 |
| Adjusted September 2004 | -310 | -202 | -187 | -183 | -166 | -142 | -861 |
| September 2004 | -348 | -298 | -308 | -318 | -312 | -298 | -2,294 |

## Total Factor Productivity



## Growth in Discretionary Budget Authority, 2004 to 2005 (Billions of dollars)

| Budget Authority | Actual 2004 | Estimated 2005 | Percentage Change |
|---|---|---|---|
| Total | 906 | 840 | -7.3 |
| Excluding Supplementals | | | |
| Defense | 394 | 420 | 6.7 |
| Nondefense | | | |
| Homeland security | 27 | 31 | 14.7 |
| Other nondefense | 368 | 377 | 2.6 |
| Subtotal, nondefense | 395 | 409 | 3.5 |
| Total Excluding Supplementals | 789 | 829 | 5.1 |

## Mandatory Outlays Under CBO's Baseline

| | Actual 2003-2004 | Estimated 2004-2005 | Projected 2005-2015 |
|---|---|---|---|
| **Average Annual Rates of Growth** | | | |
| Total Mandatory | 4.7 | 6.5 | 5.7 |
| Social Security | 4.5 | 5.1 | 5.6 |
| Medicare | 8.5 | 9.3 | 9.0 |
| Medicaid | 9.7 | 5.3 | 7.8 |

| | 2004 | 2005 | 2015 |
|---|---|---|---|
| **As a Share of Federal Spending** | 54.0 | 54.3 | 62.1 |

## CBO's Economic Projections for Calendar Years 2005 to 2015

| | Estimated | Forecast | | Projected Annual Average | |
|---|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2007-2010 | 2011-2015 |
| Real GDP (Percentage change) | 4.4 | 3.8 | 3.7 | 3.3 | 2.7 |
| Consumer Price Index (Percentage change) | 2.7 | 2.4 | 1.9 | 2.2 | 2.2 |
| Unemployment Rate | 5.5 | 5.2 | 5.2 | 5.2 | 5.2 |
| Three-Month Treasury Bill Rate | 1.4 | 2.8 | 4.0 | 4.6 | 4.6 |
| Ten-Year Treasury Note Rate | 4.3 | 4.8 | 5.4 | 5.5 | 5.5 |

Testimony inserts in response to Qs from Mr. Crapo

Q1. Can you give a basic explanation of how CBO estimates the level of demand for Medicare services per beneficiary in future years? Do you assume that the average American will be as unhealthy as the average American today?

**Answer:** For most of the major components of Medicare—such as hospital inpatient services and outpatient services, skilled nursing services, and home health services—CBO projects four components of spending growth: changes in enrollment, updates to payment rates, "excess cost growth", and the effects of changing demographics. The exceptions to that approach are spending for physician services (which is subject to a mechanism that will bring spending into line with an expenditure target that is based on enrollment growth and economic factors) and the Medicare Advantage program (in which growth in spending per enrollee is tied to the rate of growth in spending per enrollee in the fee for service sector.) Our baseline projections also take into account the effects of already-enacted changes in program rules that either will take effect in the future, or that have been implemented relatively recently and are continuing to have a distinct effect on the rate of growth in program spending.

We combine three of those four components (updates, excess cost growth, and demographics—but not changes in enrollment) to project growth in spending per beneficiary:

- Updates. Payment rates for most services are adjusted for inflation each year. In some cases (such as hospital services) the measure of inflation is specific to the goods and services that hospitals purchase; in others (such as many ancillary services) the update is based on a broad measure of inflation—usually the consumer product index for urban consumers. We use CBO's macroeconomic projections as the basis for projecting those updates.

- Excess cost growth. Medicare spending per beneficiary grows faster than the updates to payment rates—because the number of services furnished per beneficiary tends to increase over time and because the nature of the services changes as new (and often more expensive) techniques and technologies are developed and adopted. The growth in spending in excess of the updates to payment rates that we have observed in the past incorporates the effects of all factors other than updates, so it also reflects changes in health status and longevity, and other changes in medical practice. In general, our projections assume excess growth in the near future will tend to be similar to excess growth in the recent past. That assumption is based on the expectation that past trends will continue. Those trends include both advances and setbacks. For example, certain common behaviors (such as a nutritious diet and regular exercise) probably contribute to improvements in health status, whereas other common behaviors (such as the increasing prevalence of obesity) result in deteriorating health status.

- Demographics. The age mix of Medicare beneficiaries will shift dramatically in the next decade as baby boomers approach and turn 65. The average age of aged (65 and older) beneficiaries will drop sharply, and the average age of disabled beneficiaries will increase

(because disability rates increase sharply as people approach 65.) That change in the age mix will affect Medicare spending, because spending per beneficiary tends to increase with age. We project that, as a result of the changing age mix, spending per beneficiary in 2015 will be almost 5 percent lower than it would be if the age distribution remained the same as it is now.

Q2. How do you factor in the effects that ongoing technological improvements will have on the overall cost and demand for services per beneficiary? Some studies have shown that advances in health information technology and better disease management actually lead to more expensive benefits and greater costs to the program. Do you believe this to be the case? If so, how is that factored into your baseline estimates?

**Answer:** Changes in medical technology, information technology, and other aspects of the practice of medicine are ongoing processes. As a result, the effects of those processes are reflected in the excess cost growth we have observed in the past. Implicit in our assumption that excess cost growth will continue to be similar to recent experience is the assumption that there will not be a sharp change in the near future in the net effect on spending of developments in technology and the practice of medicine.

In October 2004, CBO produced an analysis of the literature on disease management programs. On the basis of its examination of peer-reviewed studies of disease management programs for congestive heart failure (CHF), coronary artery disease (CAD), and diabetes and the conclusions reached by other reviews of the relevant literature published in major medical journals, CBO found that to date there is insufficient evidence to conclude that disease management programs can generally reduce the overall cost of health care services.

Q3. Suppose the American people begin to understand the tremendous cumulative burden that their personal behavior is placing on the long-term fiscal picture for out country. As a result of this new understanding, suppose that over the next ten years, demand for Medicare services is reduced by 10 percent, as the American people begin taking better care of themselves and taking more responsibility for their personal behavior. How much of an impact would that have on the baseline estimate for the Medicare budget and the federal budget as a whole?

**Answer:** CBO projects that net mandatory spending for Medicare will grow from $287 billion in 2005 to $637 billion in 2015, and will total $5.0 trillion over that period. A 10 percent reduction in 2015 would result in net mandatory spending of $573 billion, or $64 billion less than in CBO's January 2005 baseline projection. If that 10 percent reduction were achieved by reducing mandatory spending for Medicare by 1 percent in 2006, and by an additional percentage point in each subsequent year, net mandatory spending for Medicare would total $4.7 trillion over the 2005-2015 period.

Testimony insert in response to budget enforcement question posed by Senator Byrd

- What are your views on renewing PAYGO rules for tax cuts and spending, and what additional enforcement tools should the Congress consider to ensure credible budgets?

**Answer**: The budget process has contained a great many enforcement tools over the past thirty years. However, the broadest lesson is that no single tool can substitute for a broad consensus on budget policy. If there is a sufficient policy consensus, then the process can be tailored to support that consensus, and indeed there is evidence of that in the past.

The same observations, it seems to me, also applies to the statutory mechanisms that expired in 2002. Multiyear discretionary spending caps, as were in place in the 1990s, and PAYGO rules are most advantageous when they support a consensus on budget policies and tradeoffs. They are not a substitute for such a consensus.

**Economic Growth Rates** Robert C. Byrd

Director Holtz-Eakin,

For your projections of the Social Security long-term deficit, what is the assumed average annual growth rate in the economy? What was the average annual growth rate for the last 75 years? What was the average annual growth rate over the last ten years?

**From:** Michael Simpson
**To:** Brian Plummer
**Date:** 2/4/2005 3:42:53 PM
**Subject:** Answer to Byrd question on real gdp growth

Brian -

In response to Sen. Byrd's quetion on real annual growth rates:

The average assumed real growth 2004-2079 is 2.0%.

The actual real growth over the last ten years (1994-2004) was 3.3%.

The actual real growth over the last seventy-five years (1929-2004) was 3.4%.

Please let me know if you have any additional questions.

- Michael

Testimony insert in response to economic growth rate questions posed by Senator Byrd from 2/1/05 Senate Budget Committee hearing entitled "The CBO Budget and Economic Outlook"

Q1. For your projections of the Social Security long-term deficit, what is the assumed average annual growth rate in the economy?

Answer: The average assumed real growth for the 204-2079 period is 2.0%

Q2. What was the annual average growth rate for the last 75 years?

Answer: The actual real growth rate over the last seventy-five years (1929-2004) was 3.4%

Q3. What was the average annual growth rate over the last 10 years?

Answer: The actual real growth over the last ten years (1994-2004) was 3.3%

# REEXAMINING THE FEDERAL BUDGET FOR THE 21ST CENTURY

**TUESDAY, FEBRUARY 8, 2005**

U.S. SENATE,
COMMITTEE ON THE BUDGET,
*Washington, DC.*

The committee met, pursuant to notice, at 10:03 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Domenici, Allard, Sessions, Cornyn, Alexander, Graham, Conrad, Nelson, Stabenow, and Corzine.

Staff present: Scott B. Gudes, Majority Staff Director; and Jim Hearn, analyst.

Staff present: Mary Ann Naylor, Staff Director; and John Righter, analyst.

## OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We are fortunate to have with us today the Comptroller General of the Government, David Walker, who does a superb job, and he has some very interesting ideas and thoughts that he wants to share with us, I know, especially about the outyear impact of contingent liabilities of the Federal Government, which I am extremely concerned about. In fact, one of my goals in this budget, although the Budget has done it in the past well, but I hope we can do it even better, is to have a very clear and transparent statement of what the liabilities are of this Government not only for the 5-year and 10-year period, but 20- and 30-year period to the extent we can project them accurately not only in the area of Medicare and Social Security, which are obviously big numbers, Medicaid, but also in the areas such as PBGC, student loans, things that are out there and maybe either somewhat sleeping or completely sleeping, but we know they are going to come back and hit us in the back of the head here with fairly high costs.

I know that the Comptroller has done a lot of work in this area, and we look forward to his presentation, which we have had a little bit of a preview of, and thank him for taking the time to come and testify.

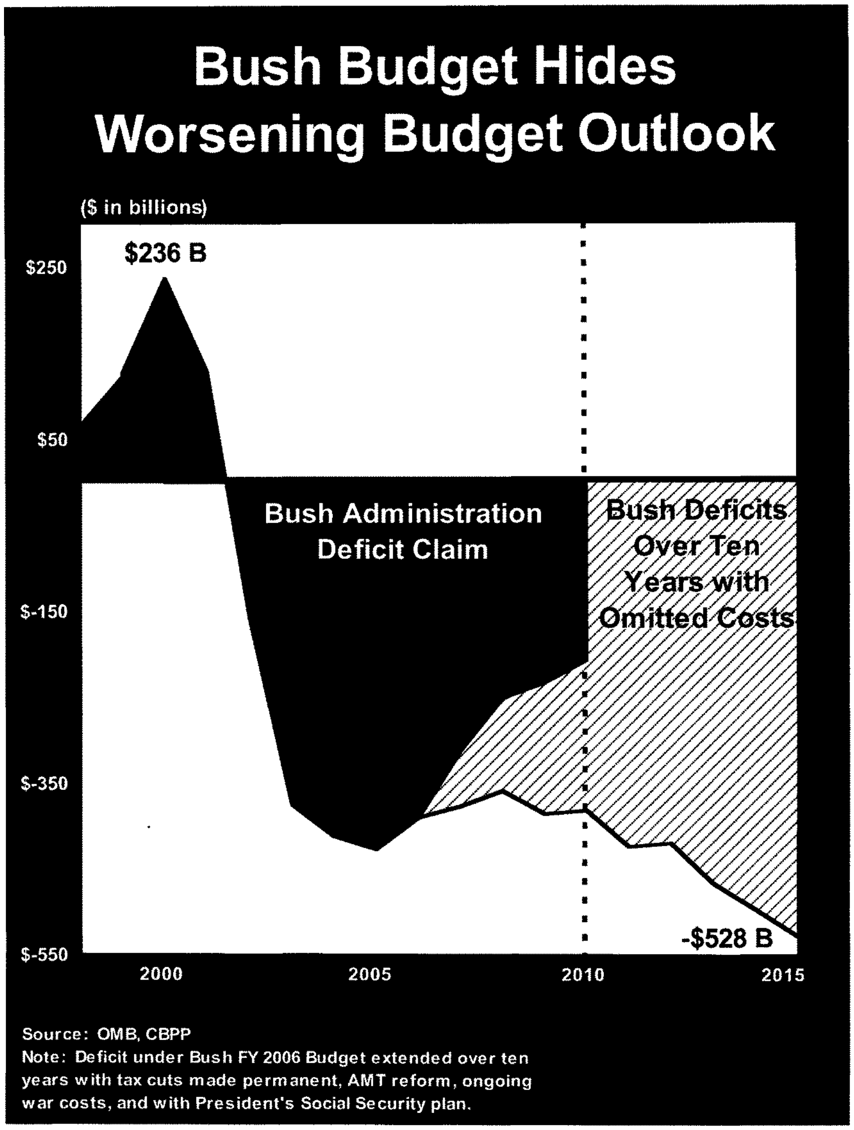
Senator Conrad.

## OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. Well, I, too, want to welcome you, Mr. Walker, to this committee. Your work has been very valuable. And I want to just go through a couple of slides, if I could, to put this in some

perspective, at least from my perspective, and then I look very much forward to your testimony.

You said, on February 2nd, to the National Press Club, “The American people need to realize that the fiscal choices being made in Washington today have profound consequences for the future of our country and our children. In a nutshell, these fiscal choices will directly affect our future national security, economic vitality and quality of life.” I think you summed it up very well. These decisions, if I were to sum up your statement, really matter. They matter to our economic security. They matter to our children.

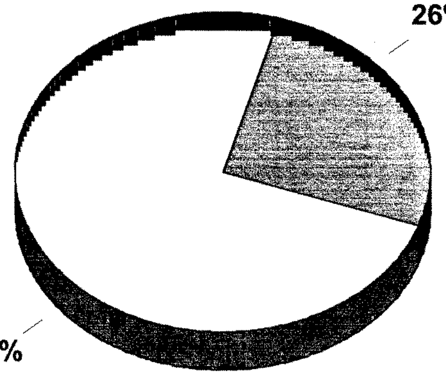

Bush Budget Hides
Worsening Budget Outlook
($ in billions)
$236 B
$250
$50
$-150
$-350
$-550
Bush Administration
Deficit Claim
Bush Deficits
Over Ten
Years with
Omitted Costs
-$528 B
2000
2005
2010
2015
Source: OMB, CBPP
Note: Deficit under Bush FY 2006 Budget extended over ten years with tax cuts made permanent, AMT reform, ongoing war costs, and with President's Social Security plan.

As I look at the President's budget, I believe it continues to push us toward bigger and bigger deficits and more and more debt. I look back to before he took office—we actually were in surplus. In fact, for 2 years, we did not use Social Security funds for other purposes. And since the President took office, we have plunged back into the red. And the President says the deficit is going to significantly improve over the next 5 years, but he only gets there by leaving out things. He leaves out war costs past September 30th of this year. He leaves out fixing the alternative minimum tax all together, which is becoming a middle-class tax trap. He leaves out the second 5 years of his tax cut, which is when the cost of it explodes. He leaves out item after item. When you put them back in, what you see is quite a different pattern than what the President is telling the Nation. And, of course, he leaves out the cost of his Social Security privatization plan.

All those things are left out. When you put them back in, here is what we see happening: A deepening of the deficit, additional debt and all at the worst possible time, before the baby boomers retire.

Let us go to the next chart.

# Revenue Loss Accounts for Bulk of Budget Turnaround Since 2000

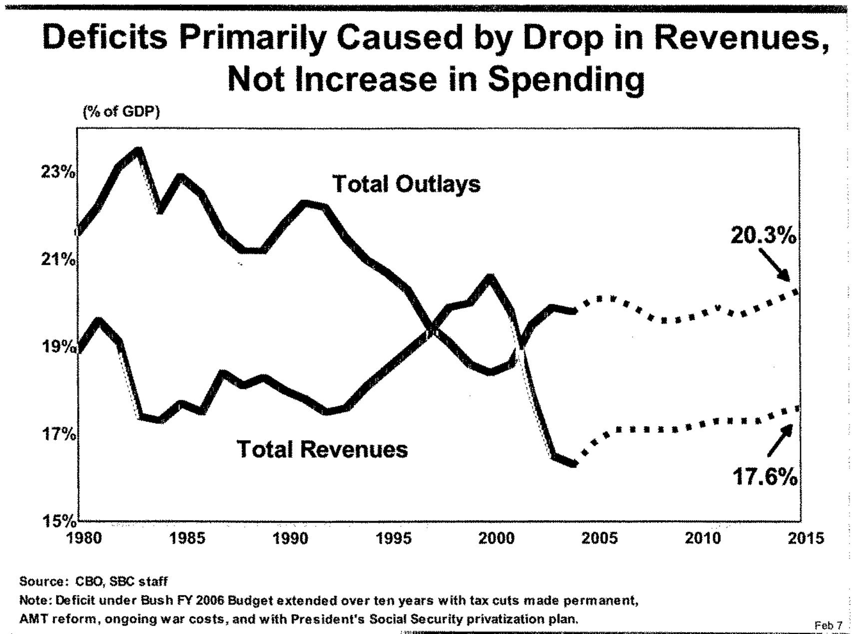



**Sources of Change from Surplus of 2.4% of GDP in 2000 to Deficit of 3.0% of GDP in 2005**

Source: CBO

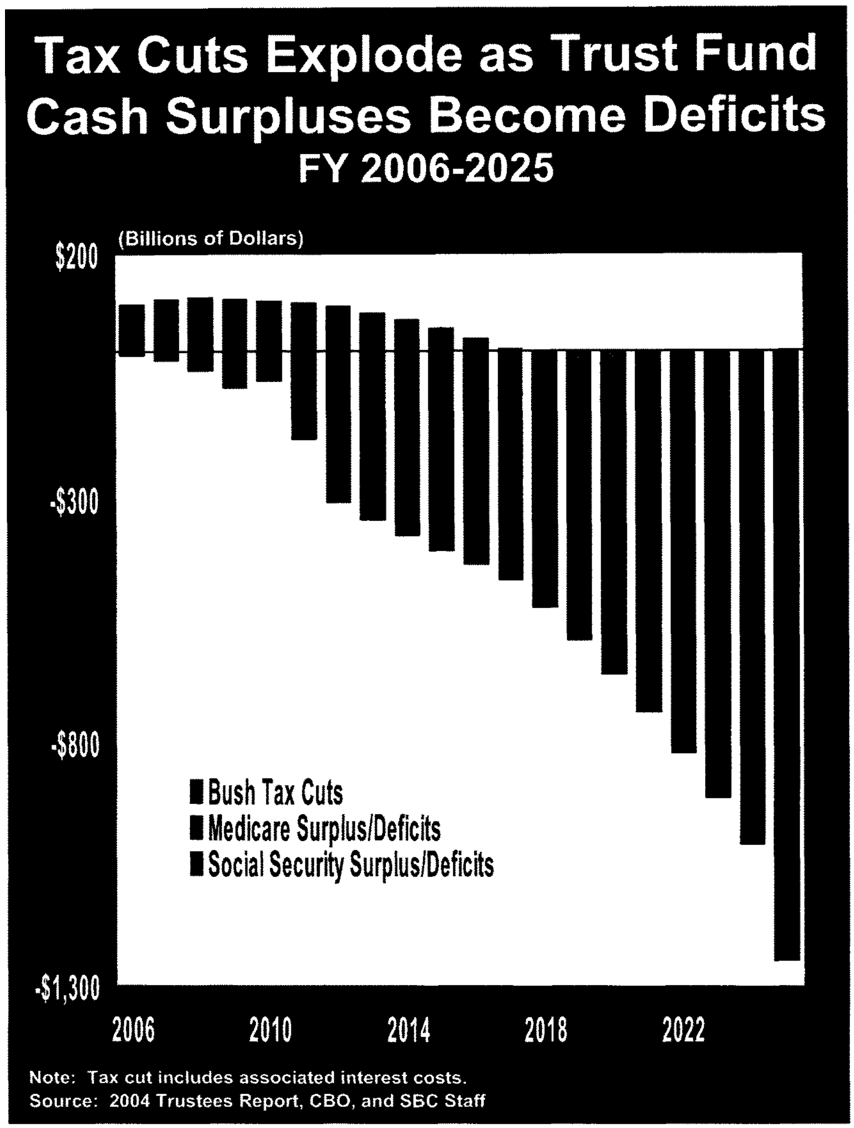
As we look at this turnaround, dramatic turnaround, from surplus to deficit, 74 percent of the reduction in our fiscal condition is a result of changes on the revenue side of the equation. Now, not all of this is tax cuts. About half is tax cuts. About half is other things. Twenty-six percent is an increase in spending. Virtually, all of the increases in spending have been for national defense and homeland security, and, of course, the big change in entitlements, the prescription drug bill that we passed, which apparently is exploding in cost as well. As Senator Gregg was concerned about, he is being proved to be correct, that the cost of that program is dramatically increasing beyond what we were told at the time.

Let us go to the next.


Deficits Primarily Caused by Drop in Revenues, Not Increase in Spending
(% of GDP)
23%
21%
19%
17%
15%
Total Outlays
20.3%
Total Revenues
17.6%
1980
1985
1990
1995
2000
2005
2010
2015
Source: CBO, SBC staff
Note: Deficit under Bush FY 2006 Budget extended over ten years with tax cuts made permanent,
AMT reform, ongoing war costs, and with President's Social Security privatization plan.
Feb 7

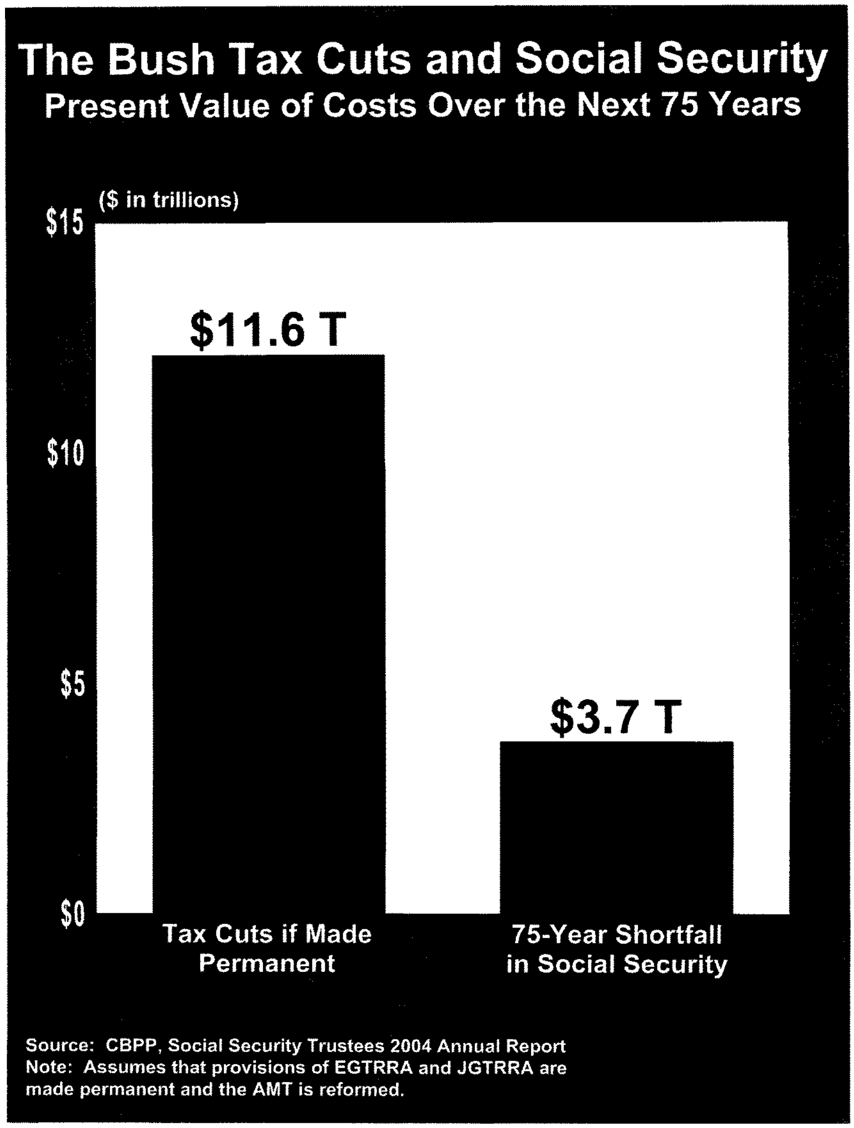
This chart I think is very important to keep in mind because it looks at spending—that is the red line, and the green line is revenue—and this goes back to 1980. We can see spending, even now, even after the increase—largely due to defense and homeland security, and rebuilding New York—we can see this spending level is still well below what it was throughout the 1980's and into the 1990's. Revenue's have had tremendous changes, and the last several years they have dramatically fallen. So we have a problem on both sides of the equation here, longer term on spending and also on revenues, and this gap is the reason for the deficit.

Let us go to the next.


Tax Cuts Explode as Trust Fund
Cash Surpluses Become Deficits
FY 2006-2025
(Billions of Dollars)
$200
-$300
-$800
-$1,300
2006
2010
2014
2018
2022
Bush Tax Cuts
Medicare Surplus/Deficits
Social Security Surplus/Deficits
Note: Tax cut includes associated interest costs.
Source: 2004 Trustees Report, CBO, and SBC Staff

The President says to us we have a deficit problem, and then he increases spending this year, 2004 to 2005, spending is increasing 8 percent. Next year, according to our calculations, they will go up another 5 percent. But the President is also saying make the tax cuts permanent. And when you overlay that against what is happening to the trust funds of Medicare and Social Security, what you see is the tax cuts explode just as the trust fund cash surpluses become deficits. The combined effect is to drive us deeper and deeper into deficits and debt.

Let us go to the last one.


The Bush Tax Cuts and Social Security
Present Value of Costs Over the Next 75 Years
($ in trillions)
$15
$10
$5
$0
$11.6 T
$3.7 T
Tax Cuts if Made Permanent
75-Year Shortfall in Social Security
Source: CBPP, Social Security Trustees 2004 Annual Report
Note: Assumes that provisions of EGTRRA and JGTRRA are made permanent and the AMT is reformed.

This looks at the shortfall in Social Security over 75 years, $3.7 trillion. I, also, asked my staff to do an analysis of what the tax cuts, what is the 75-year cost of the tax cuts that the President has proposed, and that is $11.6 trillion. Now, the tax cuts are three times the 75-year shortfall in Social Security. Let me just say I do not conclude from that we do not have to do anything about Social Security. I believe we do. I believe we have to address the Social Security shortfall. I believe we have an even more urgent need to address the Medicare shortfall because Mr. Walker, as you have indicated, the shortfall there is eight times the shortfall in Social Security.

And so I believe we should be working on both of those problems, as well as the revenue base of the country, and I look forward to your remarks. I want to thank you for sounding the alarm that we are on a fiscal course that simply is not sustainable.

Chairman GREGG. Thank you, Senator.

Mr. Walker, we look forward to hearing your thoughts.

**STATEMENT OF THE HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES GOVERNMENT ACCOUNTABILITY OFFICE**

Mr. WALKER. Thank you, Mr. Chairman and Senator Conrad. It is a pleasure to be back before the Senate Budget Committee again, and with your approval, I would respectfully request that my entire statement be entered into the record.

Chairman GREGG. Of course.

Mr. WALKER. Thank you. I will now move to summarize it, with assistance from Ty Mitchell.

I appreciate the opportunity to be before you to talk about the Nation's long-term fiscal outlook and the challenge that it poses for our country, our children, and our grandchildren. I realize that most people are focused on the President's budget for fiscal 2006, which was just unveiled yesterday, and that is obviously a very important document. At the same point in time, I believe it is important that we think about tomorrow in order to be able to put the issues that are in that document in context, which will be debated within this body and your sister body over the coming year.

This first chart, which also is in my written statement, represents the result of GAO's latest long-range budget simulation, which we do twice a year. Our long-range budget simulation, is based upon CBO's baseline and other longer-range assumptions, based on input from CBO and others. What it shows is this is what our fiscal future looks like based on three key assumptions, which CBO is required to make, which I would respectfully suggest are not very realistic.

No. 1, no new laws will be passed. You can bet on that, but I would not bet anything on it:

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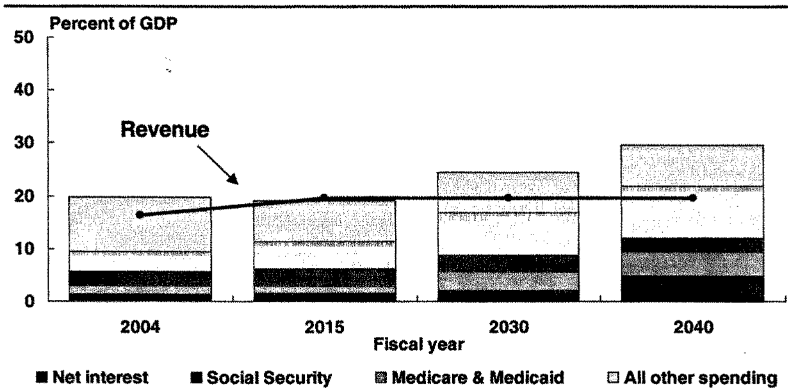
## Composition of Spending as a Share of GDP
## Under Baseline Extended




Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Source: GAO's January 2005 analysis.

Second, discretionary spending grows by the rate of inflation after 2015. Discretionary spending includes national security, homeland security, education, our judicial system, transportation, et cetera;

And, third, that all tax cuts sunset.

Those are three key assumptions that underlie this and with it you can see that we start to have serious problems starting out after 2015 that grow with the passage of time, but I would respectfully suggest you need to have alternative scenarios to look at because there are unrealistic assumptions and conditions backing this one.

The next simulation only changes two assumptions, and I am not saying this is good, bad or indifferent. I am just trying to give you the facts. The only difference between this scenario and the last is that, A, discretionary spending grows by the rate of the economy rather than the rate of inflation during the first 10 years and, B, all tax cuts are made permanent. Under this scenario, the only thing the Federal Government can do in 2040 is pay interest on the massive debt that has accumulated over that period of time.

The bottom line, Senators, is that we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. There are other factors that are contributing, clearly, including the fact that revenues, as a percentage of GDP, are at the low end of the range that they have been over a number of decades. They will come up somewhat as the economy grows, but we have a structural imbalance that is going to require very tough decisions.

I believe, Mr. Chairman, it is going to require us to do nothing less than engage in a fundamental baseline review of entitlement programs and other mandatory spending, of discretionary spending, as well as tax policies and related enforcement programs. The gap is too great to simply grow your way out of the problem. You cannot solve it just by looking at discretionary spending. You cannot solve it just looking at other mandatory spending and without looking at the entitlement programs. We also have to recognize that the Government spends hundreds of billions of dollars a year in tax expenditures through tax preferences, which are largely off the radar screen, that may or may not be achieving the desired outcomes and may or may not be affordable and sustainable in the years ahead.

Next, chart please.

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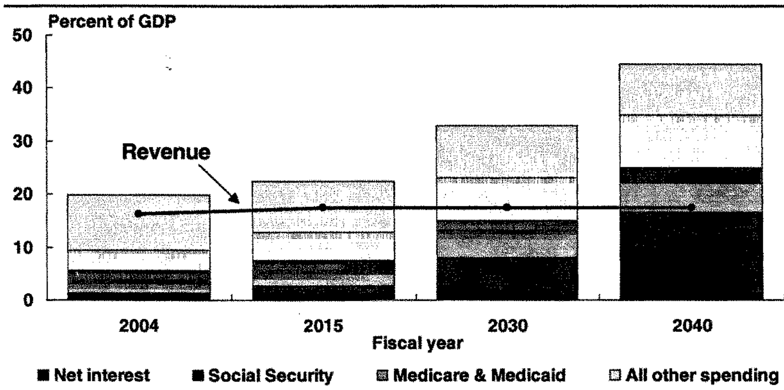
## Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP After 2005 and All Expiring Tax Provisions are Extended




Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

Source: GAO's January 2005 analysis.

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## Alternative Approaches to Using Fiscal Exposure Estimates in Budget Decisions

Approaches depend upon which primary objective is sought. A number of options could be used to implement each approach.

| | |
|---|---|
| **Primary objective:** To improve transparency of fiscal exposures | **Approach I:** Improve supplemental reporting |
| **Primary objective:** To prompt more deliberation about fiscal exposures | **Approach II:** Provide opportunities for explicit consideration of fiscal exposures in the budget process |
| **Primary objective:** To improve budgetary incentives to address fiscal exposures | **Approach III:** Incorporate cost estimates of fiscal exposures directly into primary budget data |

Source: GAO analysis.

Let me give you the bottom line on this chart, Mr. Chairman and other Senators, because there are a lot of numbers here, and these numbers, by the way, are in billions, which is a big number, in and of itself, with nine zeroes.

The bottom line here is, according to the latest financial statements of the U.S. Government for the year ended September 30, 2004, if you add up all of our liabilities, if you end up considering, also, the commitments that we have made for such programs as Social Security, Medicare, veterans health care, et cetera, and if you were to accumulate all our liabilities and commitments that existed as of September 30, 2004, and if you offset the dedicated revenues that have been earmarked for those programs, such as payroll taxes for Social Security and Medicare, premiums for certain Part B and Part D, and you only consider the portion that the taxpayers will have to fund, then our accumulated liabilities and commitments exceeded $43 trillion as of September 30, 2004. That is about $350,000 per full-time worker, and it is a big number, and it is growing every day, due primarily to demographic trends.

Next, chart please. And one of the problems that we have is, is that these numbers are largely off the radar screen, and Congress does not have access to this type of information as part of the normal budgetary process and as part of legislative deliberations, as evidenced by the fact, Mr. Chairman, that you talked about the Medicare prescription drug bill. There was a great debate last year about whether the cost was $395 billion or $534 billion, depending upon who you asked and when. The real number came out about 3 months after the bill was passed, according to the annual report of the Medicare trustees and their actuaries—$8.1 trillion. That is the estimated current dollar cost of the Medicare prescription drug benefits. That is how much money we would have to have today invested at Treasury rates to deliver on the unfunded promise for the next 75 years alone, and it is going up every day. That is more than the entire debt of the United States outstanding since the beginning of the republic, which is about $7.6 trillion, I believe.

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## Selected Fiscal Exposures: Sources and Examples 2004[a]

| Type | Example (dollars in billions) |
|---|---|
| Explicit liabilities | Publicly held debt ($4,297)<br>Military and civilian pension and post-retirement health ($3,059)<br>Veterans benefits payable ($925)<br>Environmental and disposal liabilities ($249)<br>Loan guarantees ($43) |
| Explicit financial commitments | Undelivered orders ($596)<br>Long-term leases ($39) |
| Financial contingencies | Unadjudicated claims ($4)<br>Pension Benefit Guaranty Corporation ($96)<br>Other national insurance programs ($1)<br>Government corporations e.g., Ginnie Mae |
| Exposures implied by current policies or the public's expectations about the role of government | Debt held by government accounts ($3,071)[b]<br>Future Social Security benefit payments ($3,699)[c]<br>Future Medicare Part A benefit payments ($8,236)[c]<br>Future Medicare Part B benefit payments ($11,416)[c]<br>Future Medicare Part D benefit payments ($8,119) [c]<br>Life cycle cost including deferred and future maintenance and operating costs (amount unknown)<br>Government Sponsored Enterprises e.g., Fannie Mae and Freddie Mac |

[a] All figures are for end of fiscal year 2004, except Social Security and Medicare estimates, which are as of January 1, 2004.

[b] This amount includes $845 billion held by military and civilian pension and post-retirement health funds that would offset the explicit liabilities reported by those funds.

[c] Figures for Social Security and Medicare are net of debt held by the trust funds ($1,531 billion for Social Security, $256 billion for Medicare Part A, and $24 billion for Medicare Part B) and represent net present value estimates over a 75-year period. Over an infinite horizon, the estimate for Social Security would be $10.4 trillion, $21.8 trillion for Medicare Part A, $23.2 trillion for Medicare Part B, and $16.5 trillion for Medicare Part D.

Source: GAO analysis of data from the Department of the Treasury, the Office of the Chief Actuary, Social Security Administration, and the Office of the Actuary, Centers for Medicare and Medicaid Services.

Revised 1/25/05.

So one of the things I know you are interested in, Mr. Chairman, and other members of the committee, is what can be done to try and help provide more transparency and to provide more safeguards with regard to considering not only the short-term costs, but the long-term affordability and sustainability of decisions that you have to make on an ongoing basis as a member of the U.S. Senate.

My written statement has a lot of details. I will touch on three high-level points:

First, there clearly is a need for more transparency. There is clearly a need to provide supplemental information as part of the budget process as to the number nature and magnitude of the existing unfunded commitments that we already have;

Second, there is clearly the need to consider additional mechanisms, through the legislative process, whether it be points of order, triggers or otherwise, whereby this body and your sister body would have the opportunity, if not be required, to discuss and debate the cost not only in the short term, but the long term cost, of various legislative proposals;

And, third, there is a need to consider, for certain types of items, whether or not we ought to move more toward an accrual-based approach for things like insurance, or Federal employee pension and health obligations, where accrual-based concepts have clearly existed for many years in the private sector and, some, State and local Governments, I might add. So, therefore, we might want to consider whether or not there is additional transparency that is necessary there, either through an accrual-based approach or, if not an accrual-based approach, further supplemental disclosures.

Next chart, please.

## Alternative Approaches to Using Fiscal Exposure Estimates in Budget Decisions

Approaches depend upon which primary objective is sought. A number of options could be used to implement each approach.

| | |
|---|---|
| **Primary objective:** To improve transparency of fiscal exposures | **Approach I:** Improve supplemental reporting |
| **Primary objective:** To prompt more deliberation about fiscal exposures | **Approach II:** Provide opportunities for explicit consideration of fiscal exposures in the budget process |
| **Primary objective:** To improve budgetary incentives to address fiscal exposures | **Approach III:** Incorporate cost estimates of fiscal exposures directly into primary budget data |

Source: GAO analysis.

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## Strategic Plan Themes

- Long-Range Fiscal Challenges
- Changing Security Threats
- Increasing Global Interdependence
- The Changing Economy
- Demographic Shifts
- Science and Technology Advances
- Quality of Life Trends
- Changing Governance Structures

The other thing I want to bring to the Senators' attention is the fact that, as you know, every 2 years we update our strategic plan for serving the Congress, and we do that through outreaching to members and key staff on both sides of the aisle and, both ends of the Hill, to try to help us do a better job in serving you, and you do a better job in serving your constituents. These are the latest themes in our strategic plan, which were validated by the members. These are trends and challenges that have no geopolitical boundaries, domestically and internationally, and that serve to frame the work that we do for the Congress and, hopefully, improve its value and contextual sophistication.

They are pretty much self-explanatory. But the first one, which overrides everything, is our long-range fiscal challenge because it overrides everything that we are doing or thinking about doing today and for tomorrow. The others speak for themselves, so I will not go through them, but I think they are fairly compelling.

Next chart, please.

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## Generic Reexamination Criteria

**• Relevance of purpose and the federal role**
E.g., Have there been significant changes in the country or the world that relate to the reason for initiating it?

**• Measuring success**
E.g., If there are outcome-based measures, how successful is it based on these measures?

**• Targeting benefits**
E.g., Is it well targeted to those with the greatest needs and the least capacity to meet those needs?

**• Affordability and cost effectiveness**
E.g., Is it using the most cost-effective or net beneficial approaches when compared to other tools and program designs?

**• Best practices**
E.g., Is the responsible entity employing prevailing best practices to discharge its responsibilities and achieve its mission?

One of the things that we are going to be doing, Mr. Chairman, that we plan to unveil on February 16th is a new product to try to help the Congress by providing input for its consideration as it deems appropriate in setting its oversight agenda and other types of activities. This report is based upon our years of work at GAO, 90 percent plus of which, as you know, is done at the request of the Congress or mandated by Congress, as well as based upon my experience at having run three agencies in the Government, two in the executive branch, and one in the legislative branch.

I would respectfully suggest a vast majority of the Federal Government, whether it be on the mandatory spending side, the discretionary spending side or the tax policy side is based upon an America that existed in the 1950's and 1960's. And a vast majority of the Government is based upon an accumulation and an amalgamation of programs, policies, functions and activities that have been aggregated over the years and have never been subject to fundamental review, reexamination, or reprioritization in light of the trends that I just mentioned and 21st century realities.

Our gap is so great that we can afford to do nothing less than engage in that fundamental review and reexamination that will take as much as a generation to deal with. Obviously, the Congress has to decide what to do, when to do it, and how best to do it. But one of the things that will be included in our report, that is scheduled to be unveiled on February 16th, is a series of generic questions that should be asked about every major Federal program, policy, function and activity. These are just a few examples. There are a lot more.

For example, what is the relevance, the purpose of the Federal role? When did we put this in place? Why did we put the program in place? What were the conditions that existed? What were we trying to accomplish? And have things changed since that point in time?

Measuring success. How do we measure success? How do we know that we are making a difference on an outcome-based basis? Do the programs and the agencies have outcome-based measures? If not, why not? If they do, is the program successful based upon those measures? Same thing for tax policies. What were we trying to accomplish? How do we measure success? Are we successful based upon those measures? Targeting benefits. All too many times the decision is to try and do it for everybody, rather than base it on need, value and risk. And in a time of constrained resources, you may not be able to afford to do it for everybody or sustain it if you try to do so.

Affordability and cost effectiveness. Are we using the most cost-effective and beneficial approaches in trying to achieve the objective while employing best practices? If the program makes sense, is it still a priority. Does it have outcome-based measures? It is being successful based upon those outcome-based measures? Are they employing best practices in order to accomplish their mission as economically, efficiently and effectively as possible?

Next chart, please.

## Twelve Reexamination Areas

**MISSION AREAS**

- **Defense**
- **Education & Employment**
- **Financial Regulation & Housing**
- **Health Care**
- **Homeland Security**
- **International Affairs**
- **Natural Resources, Energy & Environment**
- **Retirement & Disability**
- **Science & Technology**
- **Transportation**

**CROSSCUTTING AREAS**

- **Improving Governance**
- **Reexamining the Tax System**

This document will also divide the Government into 12 areas. Based on our strategic plan, which was developed in conjunction with the Congress and to serve the Congress. It is going to take these areas, which span all of Government, on the spending side and the tax side, and it is going to raise a series of illustrative questions that we would respectfully suggest that the Congress may wish to consider, as it deems appropriate, in looking at the base of Government.

Next chart, please.

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## Examples of 21st Century Questions For Selected Areas

**DEFENSE**

How should the historical allocation of resources across services and programs be changed to reflect the results of a forward-looking comprehensive threat/risk assessment and a capabilities-based approach to determining defense needs?

**HEALTH CARE**

How can "industry standards" for acceptable care be established and payment reforms be designed to bring about reductions in unwarranted medical practice variation? What can or should the federal government do to promote uniform standards of practice for selected procedures and illnesses?

**RETIREMENT & DISABILITY**

How can federal disability programs, and their eligibility criteria, be brought into line with the current state of science, medicine, technology, and labor market conditions?

**TAX SYSTEM**

Which tax incentives need to be reconsidered because they fail to achieve the objectives intended by Congress, their costs outweigh their benefits, they duplicate other programs, or other more cost effective means exist for achieving their objectives.?

Let me give you four examples, if I can:

There will be many questions presented, and they will be balanced. And, by the way, we will not give answers because we are not elected officials. You are elected officials. We do, however, stand ready to assist the Congress in getting additional facts, come up with options and identify pros and cons, if you so desire. However, we think that our future fiscal gap is so great that the time has come that we need to help the Congress try to be able to at least raise some of the questions that it might wish to consider, but only you can decide whether, when and how best to proceed.

Defense. How should the historical allocation of resources across the services and programs be changed to reflect the results of a forward-looking, comprehensive threat and risk assessment and a capabilities-based approach to determining defense needs? Bottom line, we are talking about the need to look at credible threats and risks, what capabilities are necessary to address those threats and risks, and how you allocate resources to the different services and other entities that are part of the Department of Defense in order to maximize the impact and mitigate risk? That is not being done right now. A vast majority of the resources of the Defense Department are allocated based on methodologies that have been used for decades.

Health care. How can industry standards for acceptable care be established and payment reforms be designed to bring about reductions in unwarranted medical practices, as well as related liability concerns? What can or should the Federal Government do to promote uniform standards of practice for selected procedures and illnesses? Now, there are many, many questions under health care. This is but one that is designed to address quality, cost, litigation access and other issues.

Retirement and disability. Believe it or not, our definitions of disability have not been updated for decades. In the case of the Defense Department, the last time it was updated was 1945. Things have changed a little bit since 1945.

The tax system. What tax incentives need to be reconsidered because they may not be achieving the intended objectives? For example, the largest tax incentive in the Internal Revenue Code today is for health care. Individuals never pay income tax on employer-provided and paid health care or payroll tax irrespective of how much money is involved and what percentage of their compensation is being represented by health care. That is an area I think you need to look at, how much money is involved, what type of incentives is it creating and what type of impact is it having with regard to our ability to control health care costs.

In summary, Mr. Chairman, the Congress, obviously, is focused on what to do with the budget that is being proposed, and that is important, but it is also important to be able to consider the size, the nature, the extent, the magnitude, and the driving forces behind our large and growing long-range fiscal imbalance. Addressing this imbalance is going to require a considerable effort over many years. It is going to have to involve discretionary spending, as well as mandatory spending, including entitlement programs, as well as tax policy, including tax preferences and enforcement efforts. It is going to have to involve all three because the numbers are simply

too great, and realistically there is no way, we are going to grow our way out of our fiscal imbalance. The math just does not work, and the sooner we get started, the better.

Thank you, Mr. Chairman and Senators.

Chairman GREGG. Thank you, Comptroller. That is a sobering presentation, an appropriate presentation and an important presentation. Obviously, the numbers which you cite, relative to the outyear issues, are hopefully going to cause us to reflect on what the best way is to address them—this $43-trillion number that you have cited as being basically the contingent liability of the Government, which is already in place. Other Congresses may come and add more to it, but that is in place. It is a staggering number.

I was interested in the point you made, which is an undeniable point, which is that this is driven primarily by a demographic shift in our society and the cost of health care as it relates to that demographic shift. I mean, the baby boom generation is alive, and it is headed toward retirement, and it is the bubble that has moved through the system ever since it, in the 1950's, caused the country to have to buy a whole lot more cribs and create a whole lot more kindergartens.

So we cannot deny it, and we cannot avoid it, and we need to get ready for it. That is your message, and the way you are putting it, the context of the way you are putting it is excellent because you are setting out the parameters of the problem and asking us the hard questions to resolve them. I hope we have the courage to step up on this.

On a couple of issues, to help you with transparency, what do you think the budget—the budget is a 5-year budget or it can be a 10-year budget, but it is going to be a 5-year budget I presume this year—the problem is a 30-year problem, a 40-year problem, but if we do not get to it now the problem becomes huge for us. What can we do in the budget to make the budget document a more transparent, action-oriented document that, when people look at it, they will say, wow, we have a problem here; we have to address it; this is the issue? Do you have recommendations in that area?

Also, in that context, you mentioned mechanisms to empower Members of Congress who want to raise the fiscal issues and capacities to do that. Can you go through some of those and how they would relate to a budget document that was authored this year.

Mr. WALKER. Mr. Chairman, some of it has to do with the budget document and some of it has to do with what happens as a result of the legislative process that flows from the budget document. In my written testimony, I have some details, but a few examples I would give are:

First, I think it is important, as part of the budget document, that there be more transparency about where our existing commitments are:

Second——

Chairman GREGG. How do you suggest we do that?

Mr. WALKER. Well, that could be a supplemental schedule that is provided as part of the budget document.

Chairman GREGG. Nobody looks at schedules. Give me another idea. Can we go to neon lights? I mean, is there——

[Laughter.]

Mr. WALKER. We might need a burden clock or something, but we can come back to that, Mr. Chairman, if you want.

As you know, the budget document sets the President's priorities. It has a number of proposals in it. One of the things that has to be considered as part of that budget document, is what are the long-range costs, affordability and sustainability, of those proposals that are being made through the budget document.

I also think it is important, whether they be made through the budget document or not, that, when Congress is considering legislation, it needs to consider the long-range cost, affordability and sustainability of those proposals before it actually acts on legislation. The example that I gave of Medicare prescription drugs I think is a perfect example.

Chairman GREGG. Well, if I can stop you there because my time is——

Mr. WALKER. Yes, Mr. Chairman.

Chairman GREGG. The problem is it is not the new programs—well, it was the new program when they put prescription drugs on—but it is the programs that are on the book. So how do we get back to those? Are there mechanisms, besides reconciliation, that you are recommending that get us back to those?

Mr. WALKER. What I am suggesting with regard to the base of Government, that is the accumulation and amalgamation of policies, programs, functions and activities that are there that do not get a whole lot of attention each year because the attention is what are you plussing up and what are you proposing to cut, with the assumption that the base is OK. The base is not OK.

What I am suggesting, Mr. Chairman, is that Congress needs to engage in a fundamental review and reexamination effort of the base of Government. In some cases, it is through oversight, in some cases, it may have to involve commissions. In the document that will be coming out on the 16th, we are going to give specific examples of how the Congress has addressed these types of issues in the past and potential vehicles that it may wish to use in addressing them in the future, but it is not a one-size-fits-all approach. Depending upon what the nature and extent of the challenge is, whether or not there is recognition that there is a problem that needs to get solved, whether you have enough facts, the maturity of the issue, you are going to use different approaches.

Chairman GREGG. You suggested accrual-based accounting for some of our accounts. Do you have a specific proposal on that that we could look at as a committee and possibly incorporate?

Mr. WALKER. We have made some recommendations in the past. I would be happy to get something up for you and the Committee's consideration. I do think it is important to note this. Accrual budgeting is not a panacea. There are some areas where accrual budgeting may make sense. On the other thing, what is critical is that even if you do not go to accrual budgeting, that you consider the long-term cost, affordability and sustainability of items on the front end. That is critical. And right now that, does not get done.

Chairman GREGG. And you suggested outcomes-based approaches. Can you give me a little more thought on how we would

take a program that is presently on the book and analyze it on an outcomes-based approach within a budget context.

Mr. WALKER. Well, one of the things that the President has tried to do, to the administration's credit, is to try to start looking at the results of programs, has its initiative called the Program Assessment Rating Tool. It is not perfect, by any means, but, conceptually, recognizing the need, we need to start looking at Federal programs and start asking what kind of results are they delivering with the resources and authorities that they have.

And if agencies cannot even tell you, that is a problem. And if they have not defined what type of outcomes are desired or if the Congress has not helped them to define that, that is a problem. And so I think that is a good first step, but I think it has to be expanded far beyond discretionary spending. You are not going to be able to solve the problem just looking at discretionary spending. You are going to have to look at entitlement programs and other mandatory spending as well as tax policies.

Chairman GREGG. Thank you.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. Thank you, Mr. Walker.

You talked here about $43 trillion of unfunded liabilities. Over what period is that?

Mr. WALKER. The $43 trillion? That is how much money we would have to have today to be able to deliver on promises that have already been made for up to 75 years.

Senator CONRAD. For the next 75 years. How much has that number increased in the last 4 years?

Mr. WALKER. In the last year, it increased by over $13 trillion. Fiscal 2004 was not a good year, from a financial and fiscal standpoint, and that resulted in an emphasis paragraph in our audit report.

Senator CONRAD. So just in 2004, that increased $13 trillion.

Mr. WALKER. That is correct, most of which related to Medicare, and most of the Medicare increase related to Medicare prescription drugs.

Senator CONRAD. Now, does that figure capture the proposed tax cuts?

Mr. WALKER. This is on the commitment side, the liability and commitment side. So, no, it does not capture that. That is on the revenue side.

Senator CONRAD. And what is the growth estimate that you have behind these numbers. I know that CBO and the Social Security Administration, for the next 75 years, are looking at a growth estimate between 1.8 and 1.9 percent, even though growth over the last 75 years has averaged 3.4 percent. What are the growth estimates behind these projections?

Mr. WALKER. The main drivers, Senator, are entitlement programs, Medicare being No. 1, and Social Security being another major entitlement program. What we use for assumptions on those programs are the assumptions that have been adopted by the Medicare and Social Security trustees, their so-called best-estimate assumptions. As you know, every year, they make three projections: low cost, high cost and intermediate or best estimate. And we are

using the intermediate or best estimate, so it would be their assumptions.

Senator CONRAD. So that would be an estimate of economic growth of about 1.8 percent.

Mr. WALKER. Senator, candidly, I do not know what assumptions they use. I can provide it for the record, if you would like.

Senator CONRAD. That is the testimony they have given in another committee, in the Finance Committee, specifically, just the other day, that their long-term economic growth estimate is 1.8 percent, even though the last 75 years, the economy has grown at 3.4 percent.

Now, when quizzed as to what appears to be a pretty conservative outlook with respect to growth, fairly pessimistic outlook in terms of growth, they say the major driver is a lack of new entrants to the work force; that is, that economic growth is a result of two factors—increases in productivity and new entrants to the work force. Do you agree with that basic understanding?

Mr. WALKER. Yes. It is my understanding that the primary reason that they are being more conservative with regard to future economic growth is because we will have had a dramatic decline in the rate of growth in the work force and a flattening out is going to occur.

Senator CONRAD. So, if we could have stronger economic growth, that would help address all of these problems, would it not?

Mr. WALKER. No question about it.

Senator CONRAD. And so part of our strategy has to be taking those steps that give us the biggest bang for the buck in terms of economic growth.

Mr. WALKER. Clearly, additional economic growth will help, but I would respectfully suggest, when you do the math, you are not going to get there through economic growth alone. There is still going to be a huge gap.

Senator CONRAD. I want to make very clear that while I believe we have to be aggressive at measures to increase economic growth because that helps deal with this, there is no conceivable scenario that I have seen that allows you to grow out of it. The structural imbalance is here now, which is the reference you are making.

Can I just go very quickly to the point of the $43 trillion. What makes up, in broad categories, the $43 trillion? I believe the other day you told me that Medicare is more than $20 trillion of that $43 trillion; is that correct? Did I hear you correctly?

Mr. WALKER. It is over $27 trillion.

Senator CONRAD. Medicare alone is over $27 trillion of the $43 trillion of unfunded liabilities.

Mr. WALKER. That is correct, Senator.

Senator CONRAD. And how much would Social Security be?

Mr. WALKER. About $3.7 trillion.

Senator CONRAD. About $3.7 trillion. So, just doing quick math, the Medicare problem, in terms of an underfunding, is eight times the shortfall in Social Security; is that correct?

Mr. WALKER. That is correct.

Senator CONRAD. That would tell me that our top priority ought to be looking at Medicare, and obviously we need to deal with Social Security as well. My own view is we ought to be dealing with

both of them because the Medicare problem is so enormous, and the cost escalation that you are estimating is so significant.

My time is up, Mr. Chairman.

Mr. WALKER. Mr. Chairman, if I may real quick, I agree with you that we need to be dealing with both, but I think we have to be cautious. The last time Medicare legislation was acted on by the Congress, it increased the fiscal imbalance by $8.1 trillion.

I do, however, think that it is possible to reform Social Security and exceed the expectations of every generation of Americans. And if you can do that—and I think you can—then, that would send a positive signal to the markets as to the ability of Congress to be able to address challenges before it has to and also would send a positive signal to the public that the Congress is concerned about this long-range imbalance that threatens our future.

Senator CONRAD. Could I just say, in conclusion, Mr. Chairman?

Chairman GREGG. Of course.

Senator CONRAD. Could I just say that I believe in Medicare the biggest opportunity is that 5 percent of the beneficiaries use 50 percent of the budget, the chronically ill, and we ought to focus like a laser on that population, better coordinate their care. The things that we have done so far by way of pilot programs show that if you do that, you better coordinate their care, you save big amounts of money, and you get better health care outcomes.

Chairman GREGG. Thank you, Senator.

Senator Alexander?

Senator ALEXANDER. Thank you, Mr. Chairman, Mr. Walker.

A Comptroller General's forum I guess month, that one of the participants, according to the report, suggested biennial budgeting might be one approach at making more oversight possible again. I've been looking at Congress from outside Congress for a long time, and I have always thought that. And now that I am here, I see that making the budget pushes the appropriations to a late process, leaves very little time for oversight, and then we end up with this big omnibus appropriations bill, and it is all a big mumbo jumbo.

Do you have any recommendations for us about the pros and cons of a 2-year budget which might be adjusted in the second year, if there emergencies? But would that not leave us a lot more time for structured oversight of the kind you are suggesting?

Mr. WALKER. Senator, candidly, several factors are relevant.

No. 1, that if you went to biennial budgeting, that would, theoretically, give you more time to do more things. Hopefully, one of the things that the Congress would do would be more oversight and engaging in a much-needed and long overdue baseline review of Government. I do not know that there is a guarantee that that would happen, but that would be my hope. But you need more time to be able to do it. There is no question.

Second, there are States, as you know, that have biennial budgeting. And the other thing that I would note is that we have been having supplementals every year now, and it is likely that there are going to be supplementals for several more years. They are a vehicle that could be used to adjust things if you went to biennial budgeting. So there are pros and cons, but, again, how would the

Senate and the House actually use their time if you went to biennial budgeting is a real question.

Senator ALEXANDER. Disciplining a legislative body is always difficult, but that has always appealed to me as a possibility.

Another thing, and again maybe this naive, but I have looked at Washington mostly from outside as a Governor, has there been any serious consideration, in this report you are coming up with, is there any consideration in separating the budget back into component parts? We now have a unified budget, but of course in the States we have a different approach. We take capital items, and we put them over here because those are investments for the future. And then in our State, at least, we pay them back in an aggressive way, and we see what that debt is for, and it helps us keep it under control. Then, we have an operating budget. And borrowing for the operating budget is very, very limited. And then I would guess on the Federal level, and in the States, you might have a pension budget.

Why do we not have a capital budget, an operating budget, and a pension budget? Would that not provide more transparency and would it not permit us, also, while we are in the midst of this deficit, not to squeeze out necessary investments we need to make that we might need to do for our future in higher education research development, for example?

Mr. WALKER. Well, Senator, we have done work in the past in a number of these areas, including capital budgeting. I would be happy to provide some of that information for you. I do think that we need to disaggregate more, and we need enhanced transparency. You talk about capital budgeting, which is one element. The other thing that you touch on is the so-called operating budget versus other types of programs.

We, clearly, need to be able to disaggregate, provide more transparency on these numbers, and try to be able to make more informed judgments as to what we should be investing in and what is generating a rate of return. Although I am sure that you can appreciate, Senator, that one person's investment might not be another person's investment, and being able to demonstrate that, in fact, there is a rate of return that we are getting on that investment is very important. It is easier for capital items than it is for other types of items.

Senator ALEXANDER. Well that is true. But if the States are the laboratories of democracy, and some of them are pretty big, and some of them have done this way for a long time, that is at least one place we can look to see how we might learn.

You have described to us a fiscal challenge that is new in its severity, and maybe that is a spur to these ideas.

Thank you very much.

Mr. WALKER. Thank you, Senator. One other thing I would note is the Federal Government, obviously, has a responsibility for overall fiscal policy, and what it does has a direct impact on the economy as a whole. And so that is why, while we need to look at some of these disaggregated numbers, we cannot lose sight of the unified budget because the unified budget does have economic impact.

Senator ALEXANDER. You could have, I suppose, a unified policy and a disaggregated budget.

Mr. WALKER. We should have a strategic and integrated approach to everything you do. It is just a matter of how you show the information and some additional disaggregation would be appropriate.

Senator ALEXANDER. Thank you, Mr. Chairman.

Chairman GREGG. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

I appreciate Senator Alexander's questioning in terms of how we look at investments in capital improvements and so on. I think we really should be looking at that in terms of what our values and priorities are and how we are evaluating that. I think that makes a lot of sense to take a look at that.

Thank you, Mr. Walker, for coming in.

There are a number of things I would love to ask you about as it relates to this because we really do need to be evaluating what we are doing, in terms of revenue, as well as expenditures, as well as interest payments for the long haul. And on this committee, Mr. Chairman, we really are the folks that lay out what the priorities and the values are for American families, and that is how I see this committee.

It is, also, I think, important to recognize that even though we include Social Security in the bottom line, certain streams of revenue coming in, those are dollars paid in by individuals. There is not general fund money involved in this. So we are including those dollars as it relates to what our debt is. Essentially, some would argue to mask the debt because we have it in a unified budget, but Social Security is something that has been a program where folks pay in, and then they receive a benefit out based on basically an insurance policy. So it is important we look at these numbers to say that as part of it.

But, Mr. Chairman, I find it really interesting when we look at these numbers that we have received. To put it in context, the President is proposing a nondefense, none homeland security budget, domestic budget—education, research, the environment, health care and so on—of $389 billion for next year—$389-. The deficit for next year is projected at $390-. So you literally could wipe out every penny of nondefense, nonhomeland security dollars in order to be able to wipe out the debt next year. I think that is very important for us to remember as we talk about what I view as sort of tinkering around the edges on this, in terms of how much we put into education or research and development, which I believe do spur economic activity and investments in the future. And if we are not paying attention to those things, we are going to be left behind by other countries like China and so on who are.

But I, also, wanted to put in perspective something else. If you take out Social Security, you are saying that our interest payments will be $213 billion next year, interest. It would be $415- if we included Social Security. So, if we take that out, $213 billion that does not educate a child, does not provide health care, does not build a road. It is interest. And the cost of the tax policy that we passed, the cost for 2006, is $252 billion. So we are paying more on that tax policy than the interest. And when you put that all together, I just hope that we will have a real honest debate about

what all of this looks like and what our priorities are in terms of the overall budget.

Now, my question. When we look at Social Security, and the fact that we are seeing Social Security is growing at a certain level and Medicare is growing at a certain level, and you have indicated that Federal health care costs will go from 4.2 percent of GDP to 11.5 percent in 2030. At the same time Social Security will go from 4.3 percent of GDP to 6 percent.

Are we not avoiding, as they would say, the "gorilla in the middle of the living room" here by not focusing on health care? There is a lot of effort going in to talking about Social Security, plans that will not even strengthen Social Security, privatizing, which I would argue do not add a day to the length of the solvency of the trust fund, but yet we are avoiding the big issue, which is the explosion in health care costs.

Mr. WALKER. I would come back to what Senator Conrad said. I think you need to work on both. I think you need to work on health care, and you need to work on Social Security. The fundamental difference is, in the case of health care, the problem is much more complex, there are huge expectation gaps. We are not only going to have to reform Medicare and Medicaid, we are going to have to reform the entire health care system in installments. It is going to be very heavy lifting. It is going to take many years. And, whereas with Social Security it is possible, with or without individual accounts to reform Social Security to make it solvent, sustainable, and secure for current and future generations and for every generation will get more than they think they are going to get.

And I think if you can achieve that, there are a lot of positive reasons why that is desirable to do, with or without individual accounts. It is going to take many years to deal with the health care problem and that is going to be very heavy lifting. So, yes, work on both, but recognize that one is a lot more solvable a lot quicker than the other one is.

Senator STABENOW. Just in conclusion, and I would agree with you that there are small changes we can make now, I would argue, instead of privatizing, but there are small changes we can make now with big impacts 5 decades from now. But, Mr. Chairman, I hope we will have a real discussion on health care. There is not a business person in Michigan I talk to, there is not a worker, there is not an older person, there is not a younger person going off of their parents' insurance that is not concerned about health care as the top priority. And there are things we can do. Allowing Medicare to negotiate for group prices would bring down the cost of the Medicare bill, and I would hope that we would aggressively begin now because it is not going to go away. It is only going to get worse and, today, I would argue it is a bigger crisis in terms of health care than it is on most other issues.

Thank you, Mr. Chairman.

Chairman GREGG. Senator Cornyn.

Senator CORNYN. Thank you, Mr. Chairman. It is good to be back on the committee this year and under your leadership. We certainly have a tough job set out for us, and it is always a pleasure

to be back on the committee with Senator Conrad and see what kind of new charts he has to show.

[Laughter.]

Senator CORNYN. I think, Mr. Walker, what you have said and what we have already heard discussed here so far is powerful refutation of those who have said that we really do not have any problem in Social Security. We really do not have a problem in Medicare, in Medicaid, and entitlement programs because plainly we do.

I know there are those who would like to point to the tax cuts as a source of all of our fiscal woes, but the fact is last year we grew about 2.5 million jobs in the country.

I believe in no small part to the economic stimulus provided by reduced taxes, which are a powerful incentive for people to work a little harder, and earn more money, and be able to keep more of what they earn. But I have two specific questions that I would like to ask today. One has to do with collections—tax collections—and the other has to do with information technology.

I understand several of IRS studies suggest that increasing enforcement will lead to additional revenue. One, in particular, suggests that doubling the examination rate would increase assessments and collections by $16.7 billion. But my question is not so much about that, but estimates that we have currently working in the United States now, about six million undocumented immigrants who work in a cash economy, maybe do, maybe do not pay taxes. I know, in Mexico alone, they estimate that the value of remittances from the United States back to Mexico, by Mexicans working in the United States, is about $14.5 billion a year, Central America and other places similarly.

Do you know whether anyone in the U.S. Government has calculated the increase in revenue that might be gleaned from providing some sort of legal way, legal framework, for undocumented immigrants, that 6 million who are currently working in the economy, to work and pay taxes?

Mr. WALKER. Senator, I am not aware of any study that has been done on that. I can check with my staff and see if they are aware of anything, and if we can come up with anything I would be happy to provide it to you.

Senator CORNYN. That would be great. I would appreciate that very much.

My second question has to do with information technology, and I will give you a quick background. When I was in State Government—attorney general—we had a broken computer system that basically monitored child support payments, and it was a disaster. It was a huge, complex project, but we ultimately got those problems worked out.

When I see that the FBI, for example, is going to throw away $100 million of taxpayer money because of a poorly conceived, poorly executed computer upgrade, I just wonder how much of that is happening out of our sight and how much waste of taxpayer money and poor execution on the part of Government agencies because they do not have the technology in place that provide better services to the American taxpayer. Can you give us any insight or any thoughts about what we can do, what we should be doing to address that waste and lack of poor services?

Mr. WALKER. Senator, GAO issued its latest update of its high-risk list the last week of January, and on that high-risk list there are several examples of different departments and agencies that have serious problems in this regard. You mentioned the FBI's latest problem. Probably the biggest problem that exists right now is at the Defense Department. The Defense Department has 14 of 25 high-risk areas. They added two more this year. Many of them have been on the list for years. If you take information technology as an example, they have over 4,000 legacy information systems that are not integrated, and that is the latest count. Every time I go over there, it goes up.

And so part of it is getting control of what we have and then creating a more positive future and making sure that we streamline our processes, define what our standards need to be and to make sure that we do not just turn it over to contractors. We have to have enough people to manage cost, quality and performance in any type of contracting activity. We have many different recommendations and I would be happy the talk to you about it separately if you want.

Chairman GREGG. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman. Welcome, Mr. Walker.

Let me try to frame this a little bit, and I am going to back into a question that deals with shifting costs to the States. You have identified big programs that are going to drive the future expenditures, entitlement programs, if you will, at the Federal level. We are operating at something like 16.5, 16.7 percent of GDP in revenues to the Federal Government, and the average over——

Senator DOMENICI. Would the Senator yield on that? How much did you say?

Senator CORZINE. I think it is something like 16.5, 16.7. Memory does not serve me for the last digit, but the average is slightly over 18 percent, and the end of the 1990's was something slightly north of 20 percent.

As the Federal Government has decreased the amount of revenues it has taken, and we have not changed the mandates to States and we have not changed the entitlement policies, have we not just shifted tax burden to our State and local governments? At least in the place I come from people have been looking at compounded rates of 7 percent increase in property taxes year over year. And we have mandates from the Federal Government on education and a whole host of issues that we have to deal with; such as environmental protection.

If we no longer continue, particularly in the Medicaid program—and Medicare has some of the same implications—aren't the solutions we are talking about here only just transferring exposures and responsibilities to our State and local governments? So that we take it out of one pocket, or we give it out of one pocket and get it taken out of in another pocket. I would love to hear your comments on it because it seems to be a pattern that is happening over and over. I happen to be a little more sensitive to it today than maybe I was 6 months ago, but it certainly is an analysis that absolutely, I think, needs to be raised in this context.

We can make ourselves feel good here under certain circumstances, but all we are doing is offloading this on other poor, unwilling folks that have to meet mandates. I wonder if you could comment.

Mr. WALKER. Senator, I think it is important to consider the ripple effects of whatever decisions are made at the Federal level, because to the extent that the Federal Government decides that something needs to get done, but it may or may not want to fund it itself, or it may only want to fund part of the cost, then the question is, who is going to end up making up the difference?

As you know, the fastest growing cost at the State level is Medicaid. In fact, Medicaid is among the largest budget item in my States budget. So that brings me back to the issue of health care. It is not just Medicare. It is Medicaid. It is the entire health care system, not just for the Government but for employers, that we have to look at.

So it is facts and circumstances. It depends upon the area that you are talking about. I know that there are going to be proposals with regard to Medicaid, GAO itself has found instances where States, have used the rules in a way to try to get more of a reimbursement than arguably they should have. We have made related recommendations to the executive branch.

I also know of examples where the formulas for transportation spending should be changed. So I think it is facts and circumstances. But you are exactly correct in saying that a number of instances where the Federal Government does less and yet it still wants to see national progress, that can put additional pressure on the States and one needs to consider that, hopefully, in your deliberations.

Senator CORZINE. Just changing subjects. I think I have a split second here. Do you have a view on PAYGO rules, two-way PAYGO rules with respect to revenues as well as spending?

Mr. WALKER. Senator, I am a bottom line person. The bottom line means, whether it is red or whether it is black, and how big it is on the bottom line. Obviously, red being a deficit and black being a surplus, which we probably will not see any time soon. I believe it is important that you consider both sides of the ledger. You should consider both the tax side and the spending side when you adopt PAYGO rules and when you should consider the long term cost, affordability and sustainability of legislative proposals.

Now reasonable people can and will debate that, and obviously, to the extent that you have certain tax actions that could be stimulative, that should be considered. But not all tax cuts are stimulative, and not all spending is necessary. But I think exempting one-half of the ledger from the analysis will help our bottom line, or help us deal with our long range fiscal imbalance.

Chairman GREGG. Senator Domenici.

Senator DOMENICI. Mr. Chairman, thank you very much. First, I want to thank you for today's testimony, in particular for the constructive ideas that you have given us. I am going to try to do two or three and see if you will answer them. That might permit me to cheat on the time. I am not sure. Maybe your answer will take all 5 minutes plus some more.

First, we gave you a job once that we called a trade-in trade-out assessment, and that had to do with looking at Federal programs to see how many programs did the same thing. The goal was for us to try up here, when we start a new program, to trade a new one in for trading out some old ones. You did a series of studies on that. I wonder if you would give us that again, and then take what the President has suggested as terminations and do an analysis of those in the same way. If he is eliminating something, what other programs are there that do the same thing?

I am trying to figure out a budget way to push that. Right now, Committee members and the Chairman, as I told him yesterday, we know that a budget resolution does not do that. It just plugs in the numbers, but then there is nothing that requires that you do that. Say you got rid of 15 programs, they may never show up in appropriations bills and we may never get an authorizing bill to do it because you cannot pass it.

So if you would do that, it would help us. I am thinking about a reverse reserve where you would set up the reserve and get a bonus if you cut a program, and lose the bonus if you did not, as part of a budget resolution. But I will work on that, and give it to the Chairman and ranking member myself. You can talk about that in a minute.

Second, you mentioned in answer to the ranking member that growth was dependent upon entrants to the marketplace, workers entering the marketplace, and productivity. And he said, if we had more growth we would be able to hire more people. But which comes first? What if we had 5 million more immigrants—do not say that out loud, but what if we did, would that help the economy? If not, why not?

And my last question has to do with outyear obligations. We keep mentioning outyear deficits or outyear obligations, and that we need to do something about them. You keep mentioning that obviously we have to reform Medicare. Doesn't reform mean that we cannot afford the size of the program? Why do we call it reform? Why shouldn't we say restrain it? Why shouldn't we say cut it?

My own observation—this is not an answer to the question—but the ranking member said, it looks like we ought to take on Medicare before Social Security because it is bigger. The problem is, it would be the same argument if you took on Medicare. It is almost the third rail. If it is not the third rail, it is 2.9 to one rail. So if you started doing it, it would be the same argument, you are hurting the old people; you are cutting.

So I do not know which comes first. I think which comes first is that which you can do. In that regard, you mentioned you can do Social Security reform and create more for the pensioners rather than less. I assume that means some kind of savings account, but would you tell us what that means, please?

Mr. WALKER. Thank you, Senator. Four things. First on the trade-in, trade-out I do recall that. I believe that was very early in my tenure. As you know, I have been in office about six and-a-half years, only eight and-a-half left. I would be happy to take a look at that and see how that compares with what the President is putting forward.

One of the things that we are encouraging the Administration to do is to focus on the base. The Administration has developed the Program Assessment Rating Tool (PART). They tend to look at each program and you look vertically within that department or agency. The other thing that we are encouraging the Administration to do is to look horizontally. Look at different types of activities or different types of programs where they exist in many different departments and agencies, for example, food safety. A recent one that I became aware of is financial literacy. We have over 20 Federal agencies involved in financial literacy. We do not need 20 Federal agencies, and I doubt very seriously they are even saying the same thing.

Second, more people. It depends on a number of things, including the skills and knowledge of the people. We are now in a knowledge-based economy. We need to compete based upon innovation, quality and productivity. We cannot compete on wages. So it depends to a great extent on the skills and knowledge of those people and what would they be doing and what value they would be adding.

Third, with regard to Medicare, there is no way we are going to deliver on all the Medicare promises that have been made. No way. So I think we need to recognize that reality, and I think that Medicare needs to be restructured as part of a broader restructuring of our overall health care system. I think we need to answer basically two fundamental questions which we have never answered.

First, what are broad-based societal needs in health care that irrespective of your income, irrespective of your geographic location, irrespective of a variety of other facts that from a societal standpoint there is a need that we ought to try to make sure that it is addressed? I did not say by whom. I said that it is addressed. Versus individual wants. Because individual wants are absolutely unlimited, and if there is one thing that could bankrupt the country it is health care.

Second, what is an appropriate division of responsibility between employers, individuals and the Government for addressing health care? That is going to take fundamental change in Medicare, Medicaid, employer-provided arrangements, and it needs to be done. And we are going to have to do it in installments. It is just too heavy a lift to do all at once.

Then last, Social Security. What I meant by Social Security, and as you probably recall, Senator, I have been a trustee of both Social Security and Medicare. I was a trustee of Social Security and Medicare from 1990 to 1995 so I am pretty deep in these two programs. I previously said that you have an opportunity to reform Social Security and exceed the expectations of every generation of Americans. Let me give you my family as an example of that.

My father is retired. You are not going to touch his Social Security benefits. I am a baby-boomer under 55. Most people of my generation are discounting what they think they are going to get from Social Security. I have a daughter 31, and a son 28, they are discounting it big time. They do not have confidence that Government is going to be able to deal with the issue. I am not saying it is right or wrong. That is the situation.

You therefore have the opportunity to restructure the program, making progressively greater changes the younger the person is,

with or without individual accounts, and structure it in a way that current retirees and near-term retirees will not be affected at all. They will get exactly what they have been promised and therefore they should not worry. Baby-boomers, Generation X and Generation Y will get more than they think they are going to get. You may decide that you want to have individual accounts for younger people as part of the equation. They may want it.

But my point is this, you can restructure it and everybody gets more than they think they are going to get. I call that a win. You do not have a prayer doing that in health care.

Senator DOMENICI. Thank you.

Chairman GREGG. Thank you. Excellent answer.

Senator SESSIONS.

Senator SESSIONS. Thank you, Mr. Chairman. Here we go again.

You, Mr. Walker, have given us some serious matters to think about. We thank you for that. We thank you for your agency and what it does. I would join with those who discussed this question of productivity and our projections for the future. I noticed that United States' growth this past year exceeded the other industrialized nations according to the economists and their poll expects us to outgrow every one of those nations next year, or this year that we are in. Some of that is indeed a result of our placing less burden on the private sector.

We can do several things. I think one is remember that the private sector is what drives us. It is what lifts our boats. Also, we can make the public sector more efficient and productive, saving money. Too often when we do save it though, we spend it, what we save. It is not as if we save it and then pay it down on debt. When we improve efficiency in one or more agencies it goes back in some other spending program that may or may not be efficient. So, I did want to make that point.

I know Senator Domenici just left but he is a champion of nuclear power. He believes that has a potential to increase our productivity. We have talked about all kinds of visions for the future there that when you get out 75 years I think we do not need to make ourselves too depressed because I believe something else will help us meet this challenge if we continue to invest in creativity.

You have worked on a number of things that deal with systemic problems in Government. One that I have thought about recently is concern over the nature and procedures and effectiveness of Government contracting. We contract out more now than we have done before. Sometimes those contracts are, I believe, poorly drawn and leave us less able to enforce them effectively. We had the FBI problem, as has been mentioned earlier. You have looked at that. Mr. Mueller is one of the finest FBI leaders that we have ever had, but I am sure he is not a thorough expert in how to put in a computer system. He called on GSA and they were supposed to help. But somehow we end up with a system that is not working.

The same has happened in defense. I have been impressed with the idea that some of the FEMA contracting after disasters is not effective, and it appears one reason is that the contractor themselves are required to evaluate their own performance, and that this has left a lack of evaluation there.

Do you think we can do a better job of contracting, and could that amount to real dollars?

Mr. WALKER. Senator, there is absolutely no question that interagency contracting is a new Government-wide high risk area, and there are a number of items with regard to contracting dealing with specific departments and agencies, DOD, DOE, NASA where contracting is also on the high risk list. So we are continuing to work to try to help people have the right type of controls in place, the right type of people that have the skills and knowledge necessary to manage cost, quality and performance. You can contract out the responsibility but you cannot wash your hands of it. That all too frequently is what happens. It is as if, we have hired a contractor and they are going to take care of it. No, you have to have people who can manage cost, quality and performance.

You also have to decide certain things up front in computer systems. You have to reengineer your processes. You have to decide what you need to accomplish versus what you want to accomplish, because everybody has got a dream about the computer system in the sky that can do everything and that is where you end up getting nightmares because you try to build things that you do not need and the specifications keep on changing. So, yes, we are on the case.

Last thing. Let me mention, you are correct in saying that we have the strongest economic growth of any major, industrialized nation. We are projected to continue to have it. But it will not be strong enough, because if you just do simple math on these numbers, on that second scenario it would take double-digit real GDP growth every year for decades to close that gap. It has never happened in the history of this country. It is not going to happen. So we need to get serious. Yes, we need to encourage economic growth.

The other thing is, even if you look in the short term, at last year's unified deficit which offsets the Social Security surplus—an amount equal to less than 25 percent of the FY2004 deficit had anything to do with Iraq, Afghanistan, or incremental homeland security costs. And we have not been in a recession since November 2001 and we had the strongest economic growth of any major industrialized nation. What is the other 75 percent and what are we doing about it?

Senator SESSIONS. I would just note that I will ask you also about some of the laws and rules we impose on our agencies and departments that interfere with their ability to do their job. I know that is a concern that you have and I think we can do better about that.

Mr. Chairman, my time has expired.

Mr. WALKER. We need to do a baseline review on those as well, Senator, because they have aggregated up over the years. We need to do a baseline review of those too.

Chairman GREGG. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

The information that I am getting is that Medicare is the one that is carrying the huge future liability out there, larger than any other program. What aspects of Medicare is driving those future obligations most?

Mr. WALKER. It is a variety of factors. One is just demographics, that we have more and more people that are becoming eligible for the program. It is known that it, on average, costs more money to insure senior citizens than it does younger people. Senator Conrad also mentioned the fact that a very, very high percentage of the cost for Medicare is used by a fairly small percentage of the population covered by Medicare. So there are a number of contributing factors.

Plus, health care cost increases continue to far outpace economic growth. I think one of the reasons it does is because for any system to work you really have to have three things in place: incentives for people to do the right thing, transparency to provide reasonable assurance they will because somebody is looking, and accountability mechanisms if people do not do the right thing. I would respectfully suggest, we do not have any one of the three in health care.

Senator ALLARD. How would we do that? How would you accomplish those three objectives? Is it performance standards we need to put in there? Or what is it that we do to accomplish it? Do we reduce eligibility requirements? What is it that we do?

Mr. WALKER. Senator, I honestly believe in the case of Medicare, for example, you are going to need to look at eligibility requirements. You are going to need to look at standards of practice. You are going to need to relook at prescription drug coverage. One of the things that was just announced in the new Medicare prescription drug benefits. It was just announced that under Part D you are going to be able to get Viagra. I do not know how that affects extending life.

Senator ALLARD. So if you are 65 years of age or older you can qualify for Viagra?

Mr. WALKER. Under the new Medicare prescription drug bill, that was announced within the last week. Now as you know, that program does not kick in for several years yet.

Senator I am happy to speak with you. I will tell you this, that in the document that is going to be issued on February 16 we raise a number of very thought provoking questions in this area and others that are a starting point. And the Congress may wish to ask us to do additional work to come up with specific options and the related pros and cons, which we are happy to do if you want us to do it. But we have a lot of recommendations out there already.

Senator ALLARD. I think it would be interesting to get some of that. I do not know how the other members of the Committee, maybe other committees haveten some of it. But I would be interested in it personally.

Last year is when I paid more attention to GPRA. That is how we did the performance and results, and it was put in the President's budget that he submitted to the Congress. I felt that helpful on a number of things. I have not have a chance to go clear through the budget but I assume those kind of proposals or provisions or ratings are in the budget again this year. Do you feel that that is helpful?

Mr. WALKER. There is absolutely no question that we need to understand what type of results are being achieved by various programs with the resources, the responsibilities and authorities that

they have. That is fundamental. But I would also respectfully suggest that it is not just with regard to spending. We should also do it with regard to tax policies as well.

For example, the tax incentives of health care. It is the No. 1 tax preference in the Internal Revenue Code and growing very rapidly. Is it achieving the desired objective or are we spending a lot of money there that may be fueling the health care cost increase rather than helping?

By that I mean, 80 percent-plus costs are paid for by a third party. The individuals who end up receiving the service do not necessarily even see what is being billed for. Individuals never pay income tax on the value of employer-provided and paid health care benefits, no matter how lucrative. They never pay payroll tax on it either. It is not on your W–2. It is not on your tax return. People do not really have any idea that health care costs are out of control. And to the extent that they are concerned about it, which they are, the relative burden of bearing the health care cost has changed dramatically over the last 40 years. Much more is being borne by Government. Much more is being borne by corporations than individuals, and yet corporations have to compete in a global economy.

Senator ALLARD. I see that my time is about ready to expire. Thank you, Mr. Chairman.

Chairman GREGG. Thank you.

Mr. Walker, you have raised a whole lot of very interesting to issues, but I think if you sugar it all off we do come back to how we address the issue of health care in the outyears as being probably, along with Social Security, the core issue of fiscal responsibility. You have also pointed out tax expenditures, which I hope will be taken up in this tax reform initiative that is being promoted by the President and which I strongly encourage. But if you have specific proposals on how Medicare you think should become more transparent and more responsible as to usage, we would be very interested in them.

The President in his request did not address Medicare relative to addressing the programmatic activity. In fact in the budget it is projected Medicare will jump by about 17 percent, which is the largest item by far in this proposed budget. A lot of that is a function of the drug benefit. The drug benefit has not even started yet and it is already out of control as far as I can see. So if you have some thoughts there we would be interested in them. We can maybe pass them on to some of the Finance Committee members who are members of this committee.

I will turn to Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Mr. Walker, a couple of things were said by the former chairman referencing me that I want to make very clear. He said that I have suggested more workers mean more economic growth. This is not my formulation. The head of the Congressional Budget Office and the head of the Social Security Administration in determining their projections for economic growth, say economic growth results from two things: growth in productivity and new entrants to the work force. That is the way they make their determination and projection on future economic growth. It is not my formulation. It is the economists' formulation.

The second thing he referenced was Medicare, suggesting that I say, do Medicare before you do Social Security. That is not my position. I believe we have to do both. And there is a inreference here that it is hard to do. Yes, it is hard to do, but if you are right, if the shortfall in Medicare is eight times the shortfall in Social Security, to delay beginning to address that imbalance is just a mistake, because the sooner we get at it, the better.

I have laid out very specifically here today something that I think should be pursued aggressively by this committee and the other committees of jurisdiction, and that is to focus like a laser on the 5 percent of the eligibles in Medicare who use 50 percent of the money. Five percent use 50 percent. Those are the chronically ill.

We did a pilot project with 22,000 patients in which we more closely coordinated their care. What we found is that you could reduce hospitalizations dramatically. They reduced hospitalization 20 percent. They reduced costs 40 percent, and they got better health care outcomes. The Senator indicated, he said, why not just call it a cut? I do not consider that a cut. You are spending less money but I do not consider it a cut because you are getting better health care outcomes.

What we have found is that nobody is coordinating these chronically ill people's care. Now that is not true in every case certainly, but by and large it is the case. What do we mean by that? People have a doctor, if they live in Washington they have a doctor here. They have a doctor at the beach. They have a heart specialist. They have a lung specialist. There is a lack of coordination of all these health care providers. As a result there are duplicate tests that waste a lot of money and are a drain on the patient. There are people with too many prescription drugs.

Just to be personal about it, we have found this with my own father-in-law. We went down and spread out all his prescription drugs on the table. He was taking 16 different prescription drugs. I got on the phone to his primary care doctor and I started reading through the list of the prescriptions he was taking. He said, oh, my God, he should not be taking that. That was two and-a-half years ago. He should not be taking that any more. Get to the next one; he should not be taking that along with this other drug. Those drugs interact adversely. That could send him to the hospital.

Now the problem is, the way our health care system works is you have all these different people that patients are going to. Nobody is on top of managing the overall case. I really believe this is something we have to aggressively address—this Medicare problem, this $27 trillion unfunded liability. Now that is real money, even in Washington, $27 trillion. It is by far the lion's share of our long term obligations. I really believe we have an obligation to start now, and everybody come up with their best ideas on what we could do, and maybe we would make real progress.

I thank the chair.

Mr. Walker, I want to again thank you as well. I think you have been a real leader for the country in firing the warning shot about where this is all headed, and that we have to work on all sides of this. It has got to be on the spending side, discretionary and mandatory—including entitlements. It has got to be on the revenue side of the equation as well. All of these things have to be on the table.

We have an obligation to avoid the long term serious adverse consequences of piling up deficits and debt.

Chairman GREGG. I join you in that. I join Senator Conrad in expression of appreciation. Senator Allard, one followup and then we will let the Comptroller go back to trying to straighten these things out. He has only mentioned about 200 things we need to straighten out. He may have a busy day today.

Mr. WALKER. That probably will take many years, Mr. Chairman.

Senator ALLARD. Mr. Chairman, and my colleague from North Dakota, Senator Conrad, had talked about a gatekeeper approach. I have a feeling that some of that is being done at the State level.

I think the State of Colorado, for example, we do have a primary care physician as a gatekeeper approach before they provide any benefits, and you have to go through the primary care physician and he is supposed to do that. If this is being done on a State by State basis we might already have the information out there where we can look at the way one State is doing it and another State is doing it and see if there is anything that can be reflected, bringing some efficiencies to the program. That is the only other comment that I would make. I think if we look at some of the States as to what they have been doing on that perhaps something can be extrapolated out of what they are doing.

Mr. WALKER. Yes, I think that is important, Senator. We not only look at States, we look at the private sector, and frankly, we look at other governments around the world because we lead in many things but we do not lead in everything, so we can learn. Thank you.

Chairman GREGG. I think you hear a general consensus from this committee that we would like to get your ideas that are specific, especially relative to health care and Medicare, and be able to maybe use them as a committee or at least pass them on to the committee of jurisdiction, which is the Finance Committee, of primary jurisdiction.

So thank you. Thank you for, as Senator Conrad said, putting a warning shot across the bow. Hopefully notice will be taken of it. That was the purpose of this hearing. We look forward to your report coming out on the 16th. It should be something that will be very informative and very useful for us as a Government and hopefully for people generally, and we will do whatever we can to draw attention to it. Thank you for the good work.

Mr. WALKER. Thank you, Senators.

[The prepared statement of Mr. Walker follows:]

United States Government Accountability Office

GAO

Testimony

Before the Senate Budget Committee

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Tuesday, February 8, 2005

# LONG-TERM FISCAL ISSUES

## Increasing Transparency and Reexamining the Base of the Federal Budget

Statement of David M. Walker
Comptroller General of the United States

GAO Accountability * Integrity * Reliability

GAO-05-317T

Mr. Chairman, Senator Conrad, Members of the Committee:

I appreciate this opportunity to talk with you about our nation's long-term fiscal outlook and the challenge it poses for the budget and oversight processes. Today, I will first provide the committee with the results of our most recent simulations of the long term fiscal outlook, updating a model we initially developed for members of this Committee in 1992. I will also discuss some ideas for increasing transparency of the long-term costs of government commitments and the range of fiscal exposures—work we first did at the request of your counterparts in the House.[1] Finally, I will talk about a forthcoming report that we believe will help the Congress in dealing with a range of performance and accountability issues. As this Committee knows, we periodically pull together our work for the Congress in ways we hope will help in its budget and programmatic deliberations and oversight activities.[2] Our recently issued High-Risk update is the most recent example.[3] All of these are part of our periodic efforts to provide our professional insights about programs or operations needing oversight and review through such series as high risk and budget options reports.[4]

Next week we will issue another report that builds on our past and pending work—90 percent of which is requested by the Congress or required by law—to provide policy makers with a comprehensive compendium of those areas throughout government that could be considered ripe for reexamination and review based on our past work and institutional knowledge. This report is entitled *21st Century Challenges: Reexamining the Base of Government.* In this report we with present illustrative questions for policy makers to consider as they carry out their responsibilities. These questions look across major areas of the budget and federal operations including discretionary and mandatory spending, and tax policies and programs. These questions are intended as one input among many that Congress will receive as it decides what its agenda will be for oversight and program review through its various committees. Others

[1]GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[2] See, for example, GAO, *Opportunities for Congressional Oversight and Improved Use of Taxpayer Funds: Budgetary Implications of Selected GAO Work*, GAO-04-649 (Washington, D.C.: May 7, 2004).

[3]GAO, *High-Risk Series: An Update*, GAO-05-207 (Washington, D.C.: Jan. 2005).

[4]Legislative Reorganization Act of 1970, 31 U.S.C. Section 717(b).

have formulated very detailed comprehensive agendas with specific policy proposals—the President's budget released yesterday is one very prominent example. We hope that this new report will be used by various congressional committees as they consider which areas of government need particular attention and reconsideration, recognizing that while answers to these questions may draw on the work of GAO and others, only elected officials can and should decide whether, how, and when to move forward.

The overall picture on the long term fiscal outlook is not news to this Committee. Simply put, our nation's fiscal policy is on an unsustainable course and our long-term fiscal gap grew much larger in fiscal year 2004. Long-term budget simulations by GAO, the Congressional Budget Office (CBO), and others show that, over the long term we face a large and growing structural deficit due primarily to known demographic trends and rising health care costs. Continuing on this unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security. Our current path also will increasingly constrain our ability to address emerging and unexpected budgetary needs and increase the burdens that will be faced by future generations.

As this Committee knows, the long-term outlook challenges the budget process to provide more transparency about the specific exposures that will encumber our fiscal future. While the 10-year outlook is important, Congress may wish to think more about what metrics and measures need to be added to more clearly identify the long-term consequences of current proposals before legislative action is taken. In my view, elected representatives should have more explicit information on the present value dollar costs of major spending and tax bills—before they vote on them. In my testimony, I will discuss changes in the information provided and budgetary incentives that could improve transparency, prompting more deliberation about and improving budgetary incentives to address such bills.

Regardless of the assumptions used, all simulations indicate that the problem is too big to be solved by economic growth alone or by making modest changes to existing spending and tax policies. Rather, a fundamental reexamination of major spending and tax policies and priorities will be important to recapture our fiscal flexibility and update our programs and priorities to respond to emerging social, economic, and security changes. Ultimately, this reexamination will entail a national

discussion about what Americans want from their government and how much they are willing to pay for those things. Many, if not most, current federal programs and policies, in fact, were designed decades ago to respond to trends and challenges that existed at the time of their creation. Our recent entry into a new century has helped to remind us of how much has changed in the past several decades—whether it be rapid shifts in the security threats facing the nation, the aging of our population, the globalization of economic transactions, the escalation of health care costs, increased environmental concerns, or the significant advances in technologies and transportation systems. This discussion will not be easy since there is no "low hanging fruit" in the budget, but acting sooner will enable us to avoid precipitous changes while providing more transition time.

## The Long-Term Budget Outlook

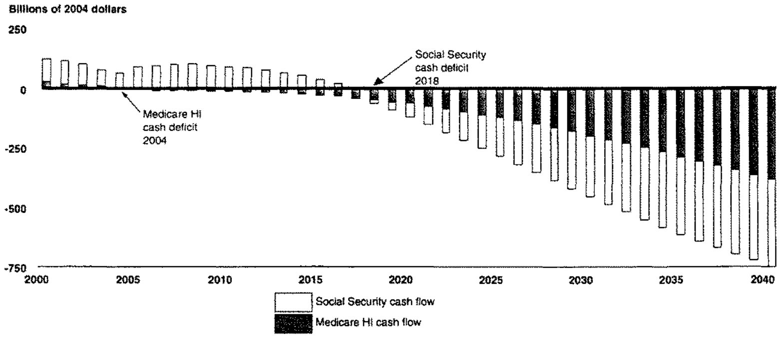
Three years ago when I appeared before this Committee, I spoke about a large and growing long-term fiscal gap driven largely by known demographic trends and rising health care costs.[5] Unfortunately, despite a brief period with budget surpluses, that gap has grown much wider. Last year's Medicare prescription drug bill was a major factor, adding $8.1 trillion to the outstanding commitments and obligations of the U.S. government in long-term present value terms. The near-term deficits also reflected-higher Defense, homeland security, and overall discretionary spending which exceeded growth in the economy, as well as revenues which have fallen below historical averages due to policy decisions and other economic and technical factors. While the size of the nation's long-term fiscal imbalance has grown significantly, the retirement of the "baby boom" generation has come closer to becoming a reality. Given these and other factors, it is clear that the nation's current fiscal path is unsustainable and that tough choices will be necessary in order to address the growing imbalance.

The cost implications of the baby boom generation's retirement have already become a factor in CBO's baseline projections and will only intensify as the baby boomers age. According to CBO, total federal spending for Social Security, Medicare, and Medicaid is projected to grow by about 25 percent over the next 10 years—from 8.4 percent of GDP in 2004 to 10.4 percent in 2015. Although the Trustees' 2004 intermediate

[5]GAO, *Budget Issues: Long-Term Fiscal Challenges*, GAO-02-467T (Washington, D.C.: Feb. 27, 2002).

estimates project that the combined Social Security Trust Funds will be solvent until 2042,[6] program spending will constitute a rapidly growing share of the budget and the economy well before that date. Under the Trustees' 2004 intermediate estimates, Social Security's cash surplus—the difference between program tax income and the costs of paying scheduled benefits—will begin a permanent decline beginning in 2008. To finance the same level of overall federal spending as in the previous year, additional revenues and/or increased borrowing will be needed in every subsequent year. (See fig. 1.)

**Figure 1: Social Security and Medicare's Hospital Insurance Trust Funds Face Cash Deficits**




Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration and Office of the Actuary, Centers for Medicare and Medicaid Services.

Note: Projections based on the intermediate assumptions of the 2004 Trustees' reports.

By 2018, Social Security's cash income (tax revenue) is projected to fall below benefit payments. At that time, Social Security will join Medicare's Hospital Insurance Trust Fund, whose outlays exceeded cash income in

[6]Separately, the Disability Insurance (DI) fund is projected to be exhausted in 2029 and the Old-Age and Survivors' Insurance (OASI) fund in 2044. Using slightly different economic assumptions and model specifications, CBO estimated the combined Social Security trust fund will be solvent until 2052. CBO, *The Outlook for Social Security* (Washington, D.C.: June 2004).

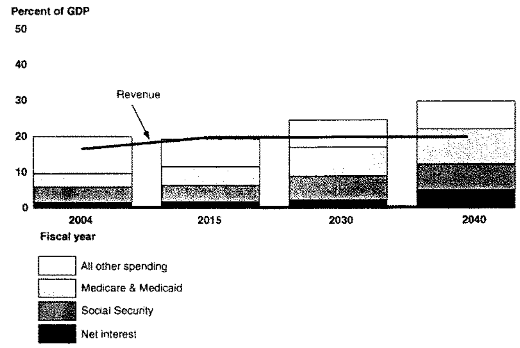
2004, as a net claimant on the rest of the federal budget. The combined OASDI Trust Funds will begin drawing on the Treasury to cover the cash shortfall, first relying on interest income and eventually drawing down accumulated trust fund assets. At this point, Treasury will need to obtain cash for those redeemed securities either through increased taxes, spending cuts, and/or more borrowing from the public than would have been the case had Social Security's cash flow remained positive.

Ultimately, the critical question is not how much a misleadingly labeled "trust fund" has in assets, but whether the government as a whole can afford the benefits in the future and at what cost to other claims on scarce resources. As I have said before, the future sustainability of programs is the key issue policy makers should address—that is, the capacity of the economy and budget to afford the commitment in light of overall current and projected fiscal conditions.

GAO's long-term simulations illustrate the magnitude of the fiscal challenges associated with an aging society and the significance of the related challenges the government will be called upon to address. Figures 2 and 3 present these simulations under two different sets of assumptions. In the first, we begin with CBO's January baseline—constructed according to the statutory requirements for that baseline.[7] Consistent with these requirements, discretionary spending is assumed to grow with inflation for the first 10 years and tax cuts scheduled to expire are assumed to expire. After 2015, discretionary spending is assumed to grow with the economy, and revenue is held constant as a share of GDP at the 2015 level. In the second figure, two assumptions are changed: (1) discretionary spending is assumed to grow with the economy after 2005 rather than merely with inflation, and (2) the tax cuts are extended. For both simulations, Social Security and Medicare spending is based on the 2004 Trustees' intermediate projections, and we assume that benefits continue to be paid in full after the trust funds are exhausted. Medicaid spending is based on CBO's December 2003 long-term projections under mid-range assumptions.

[7]The Congressional Budget Office, *The Budget and Economic Outlook: Fiscal Years 2006 to 2015*, (Washington, D.C.: Jan. 2005).

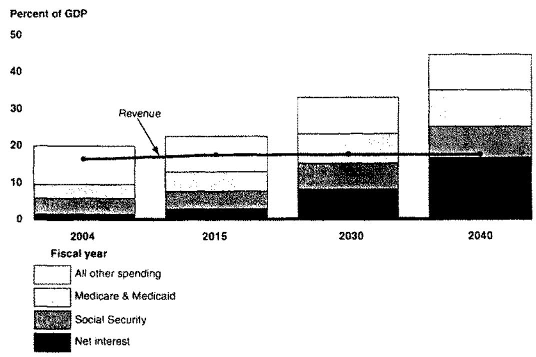
**Figure 2: Composition of Spending as a Share of Gross Domestic Product (GDP) Under Baseline Extended**




Source: GAO's January 2005 analysis.

Note: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the Alternative Minimum Tax (AMT), and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

**Figure 3: Composition of Spending as a Share of Gross Domestic Product Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended**



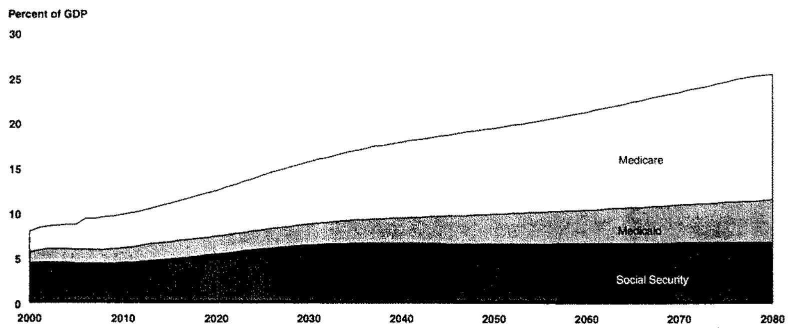

Source: GAO's January 2005 analysis

Note: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

As both these simulations illustrate, absent policy changes on the spending or revenue side of the budget, the growth in spending on federal retirement and health entitlements will encumber an escalating share of the government's resources. Indeed, when we assume that recent tax reductions are made permanent and discretionary spending keeps pace with the economy, our long-term simulations suggest that by 2040 federal revenues may be adequate to pay little more than interest on the federal debt. Neither slowing the growth in discretionary spending nor allowing the tax provisions to expire—nor both together—would eliminate the imbalance. Although revenues will be part of the debate about our fiscal future, making no changes to Social Security, Medicare, Medicaid, and other drivers of the long-term fiscal gap would require at least a doubling of taxes—and that seems implausible. Accordingly, substantive reform of Social Security and our major health programs remains critical to recapturing our future fiscal flexibility.

Although considerable uncertainty surrounds long-term budget projections, we know two things for certain: the population is aging and the baby boom generation is approaching retirement age. The aging population and rising health care spending will have significant implications not only for the budget, but also the economy as a whole. Figure 4 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2004 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 15.6 percent of GDP in 2030 from today's 8.5 percent. It is clear that, taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

**Figure 4: Social Security, Medicare, and Medicaid Spending as a Percent of GDP**




Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

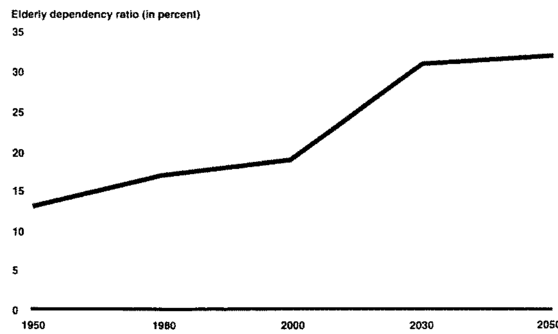
Note: Social Security and Medicare projections based on the intermediate assumptions of the 2004 Trustees' Reports. Medicaid projections based on CBO's January 2005 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under mid-range assumptions.

The government can help ease future fiscal burdens through spending reductions or revenue actions that reduce debt held by the public, saving for the future, and enhancing the pool of economic resources available for private investment and long-term growth. Economic growth is essential, but we will not be able to simply grow our way out of the problem. The numbers speak loudly: Our projected fiscal gap is simply too great. Closing

the current long-term fiscal gap would require sustained economic growth far beyond that experienced in U.S. economic history since World War II. Tough choices are inevitable, and the sooner we act the better.

The retirement of the baby boom generation is not the only demographic challenge facing our nation. People are living longer and spending more time in retirement. As shown in figure 5, the U.S. elderly dependency ratio is expected to continue to increase.[8] The proportion of the elderly population relative to the working-age population in the U.S. rose from 13 percent in 1950 to 19 percent in 2000. By 2050, there is projected to be almost 1 elderly dependent for every 3 people of working age—a ratio of 32 percent. Additionally, the average life expectancy of males at birth has increased from 66.6 in 1960 to 74.3 in 2000, with females at birth experiencing a rise from 73.1 to 79.7 over the same period. As general life expectancy has increased in the United States, there has also been an increase in the number of years spent in retirement.

**Figure 5: U.S. Elderly Dependency Ratio Expected to Continue to Increase**

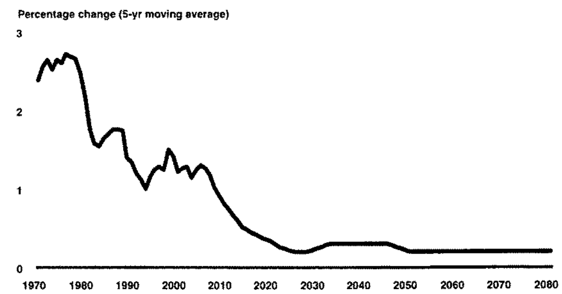



Source: Population division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Population Prospects: 2002 Revision and World Urbanization Prospects: 2001 Revision. Data for 2030 - 2050 are projected

[8]The elderly dependency ratio is the ratio of the population aged 65 years or over to the population aged 15 to 64.

A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of 3 children per woman. Today it is a little over 2, and by 2030 it is expected to fall to 1.95. The combination of these factors means that annual labor force growth will begin to slow after 2010 and by 2025 is expected to be less than a fifth of what it is today. (See fig. 6.) Thus, relatively fewer workers will be available to produce the goods and services that all will consume. Lower labor force growth will lead to slower growth in the economy and to slower growth of federal revenues. This in turn will only accentuate the overall pressure on the federal budget.

**Figure 6: Labor Force Growth Is Expected to Slow Significantly**



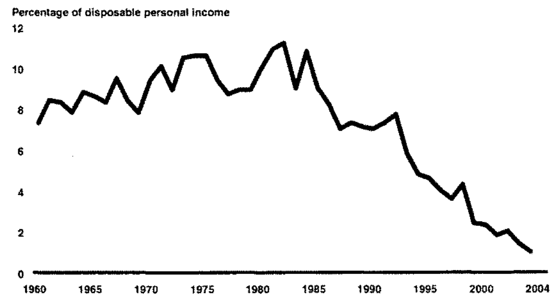

Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Note: Percentage change is calculated as a centered 5-year moving average of projections based on the intermediate assumptions of the 2004 Trustees' Reports.

Increased investment could increase the productivity of workers and spur economic growth. However, increasing investment depends on national saving, which remains at historically low levels. Historically, the most direct way for the federal government to increase saving has been to reduce the deficit (or run a surplus). Although the government may try to increase personal saving, results of these efforts have been mixed. For example, even with the preferential tax treatment granted since the 1970s to encourage retirement saving, the personal saving rate has steadily declined. (See fig. 7.) Even if the economic growth increases, the structure of retirement programs and historical experience in health care cost

growth suggest that higher economic growth results in a generally commensurate growth in spending for these programs over the long run.[9]

**Figure 7: Personal Saving Rate Has Steadily Declined**




Source: Bureau of Economic Analysis.

In recent years, personal saving by households has reached record lows, while at the same time the federal budget deficit has climbed. Accordingly, national saving has diminished, but the economy has continued to grow, in part because more and better investments were made. That is, each dollar saved bought more investment goods, and a greater share of saving was invested in highly productive information technology. The economy has also continued to grow because the United States was able to invest more than it saved by borrowing abroad, that is, by running a current account deficit. However, a portion of the income generated by foreign-owned assets in the United States must be paid to foreign lenders. National saving is the only way a country can have its capital and own it too.

The persistent U.S. current account deficits of recent years have translated into a rising level of indebtedness to other countries. However, many other nations currently financing investment in the United States also will face

[9]Initial Social Security benefits are indexed to nominal wage growth, resulting in higher benefits over time.

aging populations and declining national saving, so relying on foreign savings to finance a large share of U.S. domestic investment or federal borrowing is not a viable strategy for the long run.

In general, saving involves trading off consumption today for greater consumption tomorrow. Our budget decisions today will have important consequences for the living standards of future generations. The financial burdens facing the smaller cohort of future workers in an aging society would most certainly be lessened if the economic pie were enlarged. This is no easy challenge, but in a very real sense, our fiscal decisions affect the longer-term economy through their effects on national saving.

Early action to change these programs would yield the highest fiscal dividends for the federal budget and would provide a longer period for prospective beneficiaries to make adjustments in their own planning. Waiting to build economic resources and reform future claims entails risks. First, we lose an important window during which today's relatively large workforce can increase saving and enhance productivity, two elements critical to growing the future economy. We also lose the opportunity to reduce the burden of interest in the federal budget, thereby creating a legacy of higher debt as well as elderly entitlement spending for the relatively smaller workforce of the future. Most critically, we risk losing the opportunity to phase in changes gradually so that all can make the adjustments needed in private and public plans to accommodate this historic shift. Unfortunately, the long-range challenge has become more difficult, and the window of opportunity to address the entitlement challenge is narrowing.

## Fiscal Exposures

Although Social Security, Medicare, and Medicaid drive the long-term outlook, they are not the only federal programs or activities in which the federal government has made long-term commitments. At GAO, we are in the truth, transparency, and accountability business. A crucial first step is to insist on truth and transparency in government operations, including federal financial reporting, budgeting, and legislative deliberations. The federal government must provide a fuller and fairer picture of existing budget deficits, the misnamed "trust funds," and the growing financial burdens facing every American, especially younger Americans.

On the budget side, the current 10-year cash-flow projections are an improvement over past practices. But given known demographic trends, even these projections fail to capture the long-term consequences of

today's spending and tax policy choices. In my view, elected representatives should have more explicit information on the present value dollar costs of major spending and tax bills—before they vote on them. We believe that members of Congress, the President, and the public should have information about any long-term commitments embodied in a current policy decision. Some years ago, we developed the term "fiscal exposures" to provide a conceptual framework for considering the wide range of responsibilities, programs, and activities that may explicitly or implicitly expose the federal government to future spending.[10]

Fiscal exposures vary widely as to source, extent of the government's legal obligation, likelihood of occurrence, and magnitude. They include not only liabilities, contingencies, and financial commitments that are identified on the balance sheet or accompanying notes, but also responsibilities and expectations for government spending that do not meet the recognition or disclosure requirements for that statement. By extending beyond conventional accounting, the concept of fiscal exposure is meant to provide a broad perspective on long-term costs and uncertainties. Fiscal exposures include items such as retirement benefits, environmental cleanup costs, the funding gap in Social Security and Medicare, and the life cycle cost for fixed assets. Given this variety, it is useful to think of fiscal exposures as lying on a spectrum extending from explicit liabilities to the implicit promises embedded in current policy or public expectations. Table 1 shows some selected fiscal exposures.[11]

[10]GAO, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

[11]While this list provides some perspective on the range and magnitude of exposures facing the federal government, it is neither meant to be comprehensive nor to represent a universally agree-upon list.

**Table 1: Selected Fiscal Exposures: Sources and Examples 2004[a]**

| Type | Example (dollars in billions) |
|---|---|
| Explicit liabilities | Publicly held debt ($4,297)<br>Military and civilian pension and post-retirement health ($3,059)<br>Veterans benefits payable ($925)<br>Environmental and disposal liabilities ($249)<br>Loan guarantees ($43) |
| Explicit financial commitments | Undelivered orders ($596)<br>Long-term leases ($39) |
| Financial contingencies | Unadjudicated claims ($4)<br>Pension Benefit Guaranty Corporation ($96)<br>Other national insurance programs ($1)<br>Government corporations e.g., GinnieMae |
| Exposures implied by current policies or the public's expectations about the role of government | Debt held by government accounts ($3,071)[b]<br>Future Social Security benefit payments ($3,699)[c]<br>Future Medicare Part A benefit payments ($8,236)[c]<br>Future Medicare Part B benefit payments ($11,416)[c]<br>Future Medicare Part D benefit payments ($8,119)[c]<br>Life-cycle cost, including deferred and future maintenance and operating costs (amount unknown)<br>Government-Sponsored Enterprises, e.g., Fannie Mae and Freddie Mac |

Source: GAO analysis of data from the Department of the Treasury, the Office of the Chief Actuary, Social Security Administration, and the Office of the Actuary, Centers for Medicare and Medicaid Services.

[a]All figures are as of the end of fiscal year 2004, except Social Security and Medicare estimates, which are as of January 1, 2004.

[b]This amount includes $845 billion held by military and civiian pension and post-retirement health funds that would offset the explicit liabilities reported by those funds.

[c]Figures for Social Security and Medicare are net of debt held by the trust funds ($1,531 billion for Social Security, $256 billion for Medicare Part A, and $24 billion for Medicare Part B) and represent net present value estimates over a 75-year period. Over an infinite horizon, the estimate for Social Security would be $10.4 trillion, $21.8 trillion for Medicare Part A, $23.2 trillion for Medicare Part B, and $16.5 trillion for Medicare Part D.

As currently structured, these fiscal exposures constitute significant and in many cases growing encumbrances on the budgetary resources of the future. The current budget projections primarily focus attention on the 5-to10-year budget window. While this is an important and appropriate frame for assessing the impacts of federal fiscal policy on the economy, longer-term estimates and projections can also help provide important perspective. At the macro level, the long-term fiscal models we and CBO have developed should help frame the near-term choices we face by bringing in information on their long-term impact. At the micro level, better information on the longer-term costs of selected exposures—particularly those scheduled to grow rapidly—can help focus attention on those

program commitments presenting significant fiscal burdens over the longer term.

For example, in considering the prescription drug legislation, much controversy was focused on the specific 10-year cost estimate that should be used in the congressional consideration of this new entitlement. However, comparatively little attention was paid to the long-term costs that this new commitment would pose for future generations over a 75-year period—$8.1 trillion in present value terms, net of premiums. Since the full costs of this new entitlement increase significantly over the longer term, decision makers need to be better informed about the growth path and the impact on the nation's finances beyond the 10-year window.

The President and the Congress face the challenge of sorting out the many claims on the federal budget without the budget enforcement mechanisms—discretionary spending caps and pay-as-you-go (PAYGO) discipline—or fiscal benchmarks that guided the federal government through the years of deficit reduction into a brief period of federal surpluses. While a number of steps will be necessary to address this challenge, truth and transparency in financial reporting and budgeting are essential elements of any attempt to address the nation's long-term fiscal challenges. The fiscal risks can be managed only if they are properly accounted for and publicly disclosed, including the many existing commitments facing the government. In addition, new budget control mechanisms will be required.

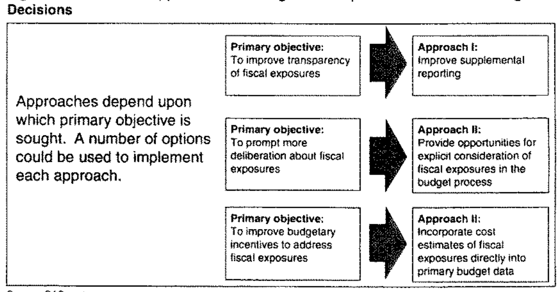
So what can we do to frame information and decisions so that decision makers can appropriately focus on fiscal exposures? The variety of certainties—and uncertainties—associated with fiscal exposures means that no single approach to increasing attention to them will work in all cases. Instead, targeted approaches for different types of fiscal exposures would, I think, be most useful for incorporating a longer-term perspective into the budget. Changes in the information provided, the budget process, or budgetary incentives could be tailored selectively for different categories of fiscal exposures to improve transparency, prompt more deliberation about them, or improve budgetary incentives to address them.

Several approaches that could be used, depending on the type of program and information available, are

- improve supplemental reporting,
- include fiscal exposures in the budget process, and
- include fiscal exposures in budget data.

Figure 8 shows these alternative approaches and relates them to the primary objective that each could help achieve. For example, approach III, in which fiscal exposure cost estimates are incorporated directly into budget data, would help achieve the objective of improving budgetary incentives to address the fiscal exposures. Each approach could be implemented in a number of ways, which I will briefly discuss.

**Figure 8: Alternative Approaches to Using Fiscal Exposure Estimates in Budget Decisions**




Source: GAO analysis

## Approach I : Improve Supplemental Reporting

Improved supplemental reporting on fiscal exposures would make information more accessible to decision makers without introducing additional uncertainty and complexity directly into the budget. Estimates of the government's exposures would be reported in various budget documents, but the current basis of reporting primary budget data—budget

authority, obligations, outlays, and deficit/surplus—would not be changed. In some cases, improving supplemental reporting may simply be a matter of highlighting or expanding existing analytical work, such as continuing and improving long-range projections and simulations of the budget as a whole. Other ways of providing additional supplemental information could be special analyses for certain significant fiscal exposures in the *Analytical Perspectives* of the budget or an annual report on fiscal exposures prepared by OMB. In the congressional budget process, greater focus could center on the long-term net present value of proposed new commitments for items where the 10-year estimate does not fully capture the dimensions of cost growth expected, similar to the Medicare prescription drug bill I mentioned earlier.

But another idea that we have discussed in the past[12] is to routinely report the future estimated costs of certain exposures as a separate notational line in the budgetary schedules in the President's budget. For example, an estimate of the future operating and maintenance costs associated with capital acquisitions could be reported as the "exposure level" for capital accounts that include the initial capital acquisition costs. Similarly, the future funding needs associated with incrementally funded projects could be included with the budget account that includes the capital acquisition. And future environmental cleanup costs associated with an asset acquisition could be handled the same way. The exposure levels might be reported in present value terms. Including them as part of the budget presentations at the account level would make such information available along with the initial costs rather than in an additional document and would clearly show the potential future costs associated with current decisions.

## Approach II: Include Fiscal Exposures in Budget Process

Budget process changes would go beyond simply providing more information on fiscal exposures to establishing opportunities for explicit consideration of these exposures. The Congress could modify budget rules to provide for a point of order against any proposed legislation that creates new exposures or increases the estimated costs of existing exposures over some specified level. Or, revised rules could provide for a point of order against any proposed legislation that does not include estimates of the potential costs of fiscal exposures created by the legislation.

[12] GAO-03-213.

A different budget process approach would be to establish triggers that address the growth in existing exposures. In that case, triggers would be established to signal when future costs of exposures rise above a certain level. Reaching the trigger would require some action. For example, the Medicare drug law enacted in December 2003 requires the Medicare trustees to estimate the point at which general revenues will finance at least 45 percent of Medicare costs. If two consecutive trustee reports estimate that this level will be reached within the next 6 years, the President is required to include a proposal in his next budget and submit legislation to change Medicare so that the 45 percent threshold will not be exceeded. Congressional committees must then report Medicare legislation by June 30. Like points of order, a trigger would require explicit consideration of exposures facing the government without adding uncertainty to primary budget data.

## Approach III: Include Fiscal Exposures in Budget Data

Incorporating estimated future costs of fiscal exposures directly into budget data by using accrual-based costs would represent the greatest change of the three approaches I have outlined today. Accrual-based costs could be used to measure budget authority and outlays for select programs when doing so would enhance obligation-based control. This approach is most suitable for explicit exposures for which reasonable cost estimates are available.

For some time we have advocated the selective use of accrual measures in the budget to better reflect costs at the time decisions are made.[13] For some major exposures, such as employee retirement benefits, insurance, and environmental clean-up costs, the use of accrual-based measurement would result in earlier cost recognition. This earlier recognition of costs improves information available to decision makers about the costs associated with current decisions and may improve the incentives to manage these costs. Because the future costs of some exposures are dependent upon many economic and technical variables that cannot be known in advance, there will always be uncertainty in cost estimates. Such uncertainty makes using accrual-based measurement directly in the budget

[13] GAO, *Budget Issues: Budgeting for Federal Insurance Programs*, GAO/AIMD-97-16 (Washington, D.C.: Sept. 30, 1997); *Accrual Budgeting: Experiences of Other Nations and Implications for the United States*, GAO/AIMD-00-57 (Washington, D.C.: Feb. 18, 2000); *Long-Term Commitments: Improving the Budgetary Focus on Environmental Liabilities*, GAO-03-219 (Washington, D.C.: Jan. 24, 2003).

more difficult. It may make sense for some exposures but not for others, because the certainty of the government's commitment and the availability of reasonable, unbiased estimates vary across the different fiscal exposures.

## 21st Century Challenges: Reexamining the Base of the Federal Government

As I noted earlier, nothing less than a fundamental review, reexamination, and reprioritization of all major spending and tax policies and programs is needed. We at GAO believe we have an obligation to assist and support you in this endeavor. So I would like to take some time this morning to tell you more about the report we will soon be issuing on reexamining the base of government—both to tell you why we are issuing this report and to illustrate some of the specific questions we plan to raise. Having identified the large and growing fiscal challenges facing the nation and the other major trends and challenges facing the United States as outlined in our strategic plan for serving the Congress, we thought we should look to our work and provide examples of the kinds of hard choices stemming from those challenges—in the form of questions for policy makers to consider. These 21st century questions will cover discretionary spending; mandatory spending, including entitlements; as well as tax policies and programs—all in one accessible volume.

Mr. Chairman, we are talking about a major transformational challenge that may take a generation to resolve. Traditional incremental approaches to budgeting will need to give way to more fundamental and periodic reexaminations of the base of government. Many, if not most current federal programs and policies were designed decades ago to respond to trends and challenges that existed at the time of their creation. If government is to respond effectively to 21st century trends, it cannot accept what it does, how it does it, who does it, and how it gets financed as "given." Not only do outmoded commitments, operations, choices of tools, management structures, and tax programs and policies constitute a burden on future generations, but they also erode the government's capacity to align itself with the needs and demands of the 21st century.

Confronting the fiscal imbalance would be difficult enough if all we had to do is fund existing commitments. But a wide range of emerging needs and demands can be expected to compete for a share of the budget pie. Whether it be national or homeland security, transportation or education, environmental cleanup or public health, a society with a growing population—and ours is projected to grow by about 50 percent by the middle of the 21st century—will generate new demand for federal action on

both the spending and tax sides of the budget. Reexamining older programs and operations may enable us to free up resources to address some of these emerging needs.

The specific 21st century questions were developed based on GAO's strategic plan, which identified major trends that will shape the federal role in the economy and our society going forward. (See table 2.)

**Table 2: Strategic Plan Themes**

| | |
|---|---|
| • Long-Range Fiscal Challenges | • Demographic Shifts |
| • Changing Security Threats | • Science and Technology Advances |
| • Increasing Global Interdependence | • Quality of Life Trends |
| • The Changing Economy | • Changing Governance Structures |

Source: GAO.

These trends, along with GAO's institutional knowledge and issued work, helped us identify the major challenges and specific questions. The specific questions were informed by a set of generic evaluation criteria useful for reviewing any government program or activity, which are displayed in table 3.

**Table 3: Illustrative Generic Reexamination Criteria**

| | |
|---|---|
| Relevance of purpose and the federal role | Does it relate to an issue of nationwide interest? If so, is a federal role warranted based on the likely failure of private markets or state and local governments to address the underlying problem or concern? Does it encourage or discourage these other sectors from investing their own resources to address the problem? |
| | Have there been significant changes in the country or the world that relate to the reason for initiating it? |
| | If the answer to the last question is "yes," should the activity be changed or terminated, and if so, how? If the answer is unclear as to whether changes make it no longer necessary, then ask, when, if ever, will there no longer be a need for a federal role? In addition, ask, would we enact it the same way if we were starting over today? Has it been subject to comprehensive review, reassessment, and reprioritization by a qualified and independent entity? If so, when? Have there been significant changes since then? If so, is another review called for? |
| | Is the current mission fully consistent with the initial or updated statutory mission (e.g., no significant mission creep or morphing)? Is the program, policy, function, or activity a direct result of specific legislation? |
| Measuring success | How does it measure success? Are the measures reasonable and consistent with the applicable statutory purpose? Are the measures outcome-based, and are all applicable costs and benefits being considered? If not, what is being done to do so? |
| | If there are outcome-based measures, how successful is it based on these measures? |
| Targeting benefits | Is it well targeted to those with the greatest needs and the least capacity to meet those needs? |
| Affordability and cost effectiveness | Is it affordable and financially sustainable over the longer term, given known cost trends, risks, and future fiscal imbalances? |
| | Is it using the most cost-effective or net beneficial approaches when compared to other tools and program designs? |
| | What would be the likely consequences of eliminating the program, policy, function, or activity? What would be the likely implications if its total funding was cut by 25 percent? |
| Best practices | If it fares well after considering all of these questions, is the responsible entity employing prevailing best practices to discharge its responsibilities and achieve its mission (e.g., strategic planning, organizational alignment, human capital strategy, financial management, technology management, acquisitions/sourcing strategy, change management, knowledge management, client/customer service, risk management)? |

Source: GAO

In the report, we will describe the forces at work, the challenges they present, and the 21st century questions they prompt, in each of 12 broad areas based in large measure on functional areas in the federal budget, but also including governmentwide issues and the revenue side of the budget. Table 4 lists those 12 areas, which involve discretionary spending; mandatory spending, including entitlements; and tax policies and programs—all of them are a part of the base.

**Table 4: Twelve Reexamination Areas**

| | |
|---|---|
| • Defense | • Natural Resources, Energy & Environment |
| • Education & Employment | • Retirement & Disability |
| • Financial Regulation & Housing | • Science & Technology |
| • Health Care | • Transportation |
| • Homeland Security | • Improving Governance |
| • International Affairs | • Reviewing the Tax System |

Source: GAO.

Our forthcoming report contains over 200 individual illustrative questions in these 12 areas. But today I would like to highlight for you—to give you a flavor of what the report will contain—several of the challenges we have inventoried in 4 of these areas, as well as some of the questions those challenges prompt.

## Defense Challenges

In the past 15 years, the world has experienced dramatic changes in the overall security environment, with the focus shifting away from conventional threats posed during the Cold War era to more unconventional and asymmetric threats evidenced by the events of September 11, 2001. Concerns about the affordability and sustainability of the rate of growth in defense spending will likely prompt decision makers to reexamine fundamental aspects of the nation's security programs, such as how DOD plans and budgets; organizes, manages, and positions its forces; acquires new capabilities; and considers alternatives to past approaches. To successfully carry out this reexamination, DOD must overcome cultural resistance to change and the inertia of various organizations, policies, and practices that became well rooted in the Cold War era.

While DOD has taken steps to meet short term operational needs, it still faces the fundamental challenge of determining how it will meet the longer term concerns of reorganizing its forces and identifying the capabilities it will need to protect the country from current, emerging, and future conventional and unconventional security threats. As DOD seeks to meet the demands of the new security environment, it continues to bear the costs of the past by maintaining or continuing to pursue many of the programs and practices from the Cold War era. Moreover, DOD faces serious and long-standing challenges in managing its ongoing business operations. Complicating its efforts are numerous systems problems and a range of other long-standing weaknesses in the key business areas of

strategic planning and budgeting, human capital management, infrastructure, supply chain management, financial management, information technology, weapon systems acquisition, and contracting. In fact, DOD alone has 8 of the 25 items and shares in the 6 cross-cutting ones on our recently-issued high-risk list.

One particular operational challenge involves managing large and growing military personnel costs, which comprise the second largest component of DOD's total fiscal year 2005 budget. The growth in military personnel costs has been fueled, in part, by increases in basic pay, housing allowances, recruitment and retention bonuses, and other special incentive pays and allowances. Health care costs have grown to comprise a larger share of the budget, reflecting expanded health care provided to reservists and retirees. As the total and per capita cost to DOD for military pay and benefits grows, we need to reexamine whether DOD has the right pay and compensation strategies to sustain the total force in the future in a cost-effective manner.

The foregoing challenges suggest certain key questions be considered by policy makers.

- How should the historical allocation of resources across services and programs be changed to reflect the results of a forward-looking comprehensive threat/risk assessment as part of DOD's capabilities-based approach to determining defense needs?
- What economies of scale and improvements in delivery of support services would result from combining, realigning, or otherwise changing selected support functions (e.g., combat support, training, logistics, procurement, infrastructure, health care delivery)?
- How might DOD's recruitment, retention, and compensation strategies, including benefit programs, be reexamined and revised to ensure that DOD maintains a total military and civilian workforce with the mix of skills needed to execute the national security strategy while using resources in a more targeted, evidence-based and cost-effective manner?

## Retirement and Disability Challenges

The challenges facing retirement and disability programs are long-term, severe, and structural in nature. For example, Social Security faces a large and growing structural financing challenge. Social Security faces this long-term financing shortfall largely because of several concurrent demographic

trends—namely, that people are living longer, spending more time in retirement, and having fewer children. Social Security could be brought into balance over the next 75 years through changes in the program and related benefits and/or taxes; however, ensuring the sustainability of the system beyond 75 years will require even larger changes.

Beyond Social Security, our nation's retirement and disability programs are further challenged by serious weaknesses that have become manifest in our nation's private pension system. Despite sustained large federal tax subsidies, total pension coverage continues to hover at about half of the total private sector labor force. The number of traditional defined-benefit plans has been contracting for decades, and recently, plan terminations by bankrupt sponsors of large defined-benefit plans have threatened the solvency of the Pension Benefit Guaranty Corporation (PBGC), the federal agency that insures certain benefits under such plans.[14] While growth in the number and coverage of defined contribution plans—where each worker has an individual account that receives contributions—has helped mitigate the decline of more traditional defined-benefit plans, these plans have also experienced problems. Policy makers will need to consider how best to encourage wider pension coverage and adequate and secure pension benefits, and how such pensions might best interact with any changes to the Social Security program.

Meanwhile, federal disability programs, such as those at the Social Security Administration (SSA) and the Department of Veterans Affairs (VA), are challenged by significant growth over the past decade that is expected to surge even more as increasing numbers of baby boomers reach their disability-prone years. Federal disability programs remain mired in concepts from the past and are poorly positioned to provide meaningful and timely support for workers with disabilities. Advances in medicine and science have redefined what constitutes an impairment to work, and the nature of work itself has shifted toward service and knowledge-based employment—these developments need to be reflected in agencies' eligibility and review processes.

[14] Recognizing the long-term challenges facing PBGC, GAO has placed PBGC's single-employer pension program on its high-risk list of programs needing further attention and congressional action. As of the end of fiscal year 2004, the agency's single-employer pension program registered a net negative accumulated position of $23.3 billion.

The mounting challenges faced by our national retirement and disability programs raise important questions. For example:

- How should Social Security be reformed to provide for long-term program solvency and sustainability while also ensuring adequate benefits and protection from disability (e.g., increase the retirement age, restructure benefits, increase taxes, and/or create individual accounts)?
- What changes should be made to enhance the retirement income security of workers while protecting the fiscal integrity of the PBGC insurance program?
- How can federal disability programs, and their eligibility criteria, be brought into line with the current state of science, medicine, technology, and labor market conditions?

## Health Care Costs, Quality, and Access Challenges

Overall health care spending doubled between 1992 and 2002 and is projected to nearly double again in the following decade to about $3.1 trillion. Despite consuming a significant share of the economy—over 15 percent of GDP—U.S. health outcomes lag behind other major industrialized nations. For example, the U.S. performs below par in infant mortality and life expectancy rates as well as premature and preventable deaths. At the same time, access to basic health care coverage remains an elusive goal for nearly 45 million Americans without insurance. Americans with good health insurance have access to advanced technology procedures and world-class health facilities, but clinical studies suggest that not all of this care is desirable or needed. Rising health costs are compelling both public and private payers to examine whether these procedures can continue to be financed without better accounting for their clinical effectiveness. Additional health care spending over time will draw resources away from other economic sectors and could have adverse economic implications for all levels of government, individuals, and other private purchasers of health care. Defining differences between needs, wants, affordability, and sustainability is fundamental to rethinking the design of our current health care system.

In the past several decades, the responsibility for financing health care has shifted away from the individual patient. In 1962, nearly half—46 percent—of health care spending was financed by individuals. The rest was financed by a combination of private health insurance and public programs. By 2002, the amount of health care spending financed by individuals' out-of-pocket

spending—at the point of service—was estimated to have dropped to 14 percent. Tax preferences for insured individuals and their employers have also shifted some of the financial burden for private health care to all taxpayers. Tax preferences can work at cross-purposes to the goal of moderating health care spending. For example, the value of employees' health insurance premiums are permitted to be excluded from the calculation of their taxable earnings and are also excluded from the employers' calculation of payroll taxes for both themselves and their employees. These tax exclusions represent a significant source of foregone federal revenue.

Public and private payers are experimenting with payment reforms designed to foster delivery of care that is clinically proven to be effective. Ideally, identifying and rewarding efficient providers and encouraging inefficient providers to emulate best practices will result in better value for the dollars spent on care. However, the challenge of implementing performance-based payment reforms, among other strategies, on a systemwide basis will depend on system components that are not currently in place nationwide—such as compatible information systems to facilitate the production and dissemination of medical outcome data, safeguards to ensure the privacy of electronic medical records, improved transparency through increased measurement and reporting efforts, and incentives to encourage adoption of evidence-based practices. These same system components would be required to develop medical practice standards, which could serve as the underpinning for effective medical malpractice reform.

In meeting these pressing health care system challenges, the following questions might be considered.

- How can technology be leveraged to reduce costs and enhance quality while protecting patient privacy?
- How can health care tax incentives be designed to encourage employers and employees to better control health care costs? For example, should tax preferences for health care be designed to cap the health insurance premium amount that can be excluded from an individual's taxable income?
- How can "industry standards" for acceptable care be established, and what payment reforms can be designed to bring about reductions in unwarranted medical practice variation? What can or should the federal

government do to promote uniform standards of practice for selected procedures and illnesses?

## Tax System Challenges

As I discussed earlier, the imbalance between federal revenues and expenditures, if allowed to persist long term, will affect economic growth and require greater scrutiny of both tax revenues and expenditures. The level and types of taxes have major impacts on the financing of government, as well as on the economy as a whole and on individual taxpayers, for both today and tomorrow.

The success of our tax system hinges greatly on the public's perception of its fairness and understandability. Compliance is influenced not only by the effectiveness of IRS's enforcement efforts, but also by Americans' attitudes about the tax system and the government. Disturbing recent polls indicate that about 1 in 5 respondents say it is acceptable to cheat on their taxes. Furthermore, the complexity of and frequent revisions to the tax system make it more difficult and costly for taxpayers who want to comply to do so, and for IRS to explain and enforce tax laws. Many argue that complexity creates opportunities for tax evasion—through vehicles such as tax shelters—which, in turn, motivate further changes and complexity in tax laws and regulations. The lack of transparency also fuels disrespect for the tax system and the government. Thus, a crucial challenge for reexamination will be to determine how we can best strengthen enforcement of existing laws to give taxpayers confidence that their friends, neighbors, and business competitors are paying their fair share.

The growing complexity of the tax system stems in part from the extensive use of tax incentives to promote social and economic objectives. The tax system includes hundreds of billions of dollars in such incentives—the same magnitude as total discretionary spending—yet relatively little is known about the effectiveness of tax incentives in achieving the objectives intended by the Congress. Furthermore, as you know, tax incentives are off the radar screen for the most part and do not compete in the budget process. They are effectively "fully funded" before any discretionary spending is considered. Incentives for savings are a particular concern: Private sector savings are near historical lows, and government savings, due to federal budget deficits, are negative. In addition, these incentives are complex, and although the issue is not completely settled, research has suggested that the incentives often do not stimulate much, if any, net new saving by individuals. As far back as 1994, we have reported that tax incentives deserved more scrutiny.

The debate about the future tax system is partly about whether the goals for the nation's tax system can be best achieved using the current structure, which is heavily dependent on income taxes, or a fundamentally reformed structure, which might include more dependence on consumption taxes, a flatter rate schedule, and/or fewer tax preferences. Increasing globalization, which makes it easier to move assets, income, and jobs across international borders, is another motivator for the debate. As policy makers grapple with such issues, they will have to balance multiple objectives, such as economic growth, equity, simplicity, transparency, and administrability, while raising sufficient revenue to finance government spending priorities. The appropriate balance among these objectives may also be affected by (1) how, if at all, to take into account that, including both the employer and employee share, an estimated two-thirds of taxpayers would pay more in payroll taxes—which are levied to fund Social Security and Medicare benefits—than they would pay in income taxes in 2004 and (2) whether and how to tax wealth.

Today's pressing tax challenges raise important questions. For example:

- Given our current tax system, what tax rate structure is more likely to raise sufficient revenue to fund government and satisfy the public's perception of fairness?

- Can we increase compliance with tax laws and reduce the need for IRS enforcement through greater use of withholding and information reporting? Could increased disclosure and penalties reduce the use of abusive tax shelters?

- Which tax incentives need to be reconsidered because they fail to achieve the objectives intended by the Congress, their costs outweigh their benefits, they duplicate other programs, or other more cost effective means exist for achieving their objectives?

- Should the basis of the existing system be changed from an income to a consumption base? Would such a change help respond to challenges posed by demographic, economic, and technological changes? How would such a change affect savings and work incentives? How would reforms address such issues as the impact on state and local tax systems and the distribution of burden across the nation's taxpayers?

## Where Do We Go From Here?

Congress faces a challenge many would find daunting: the need to bring government and its programs in line with 21st century realities. This challenge has many related pieces: narrowing the long-term fiscal gap; adapting Social Security to meet the new demographic reality; tackling the challenge of health care access, cost and quality; deciding on the appropriate role and size of the federal government—and how to finance that government—and bringing the panoply of federal activities into line with today's world. We believe that we at GAO have an obligation to assist and support the Congress in this effort. The reexamination questions discussed today and the forthcoming report of which they are a part are offered in that spirit: they are drawn primarily from the work GAO has done for the Congress over the years. We have attempted to structure questions that we hope you will find useful as you examine and act on problems that may not constitute an urgent crisis but pose important longer term threats to the nation's fiscal, economic, security and societal future.

Although it is not easy, the periodic reexamination of existing portfolios of federal programs can weed out ineffective or outdated programs while also strengthening and updating those programs that are retained. Such a process not only could address fiscal imbalances, but also improve the responsiveness, effectiveness, and credibility of government in addressing 21st century needs and challenges. Given the unsustainability of our current fiscal outlook, the real question is not whether we will deal with the fiscal imbalance, but how and when.

Given the size of the long-term fiscal imbalances, all major spending and revenue programs in the budget should be subject to periodic reviews and reexamination. While it is important to consider the role and size of government, how we finance government, and the major programs driving the long-term spending path—Medicare, Medicaid, and Social Security—our recent fiscal history suggests that exempting major areas from reexamination and review can undermine the credibility and political support for the entire process.

We recognize that this will not be a simple or easy process—there are no "quick fixes." Such a process reverses the focus of traditional incremental reviews, where disproportionate scrutiny is given to proposals for new programs or activities, but not to those that are already in the base. Taking a hard look at existing programs and carefully reconsidering their goals and their financing is a challenging task. Reforming programs and activities

leads to winners and losers, notwithstanding demonstrated shortfalls in performance and design. Given prior experience and political tendencies, there is little real "low-hanging fruit" in the federal budget. Across-the-board approaches to fiscal challenges may be easier in the short run, but they do not address the longer term fiscal cost drivers and cut both effective and ineffective programs alike.

Given the severity of the nation's fiscal challenges and the wide range of federal programs, the hard choices necessary to get us back on track in a sustainable manner may take a generation to address. Beginning the reexamination and review process now would enable decision makers to be more strategic and selective in choosing areas for review over a period of years. Reexamining selected parts of the budget base, over time rather than all at once, will lengthen the process, but it may also make the process more feasible and less burdensome for decision makers. And by phasing in changes to programs or policies that might otherwise have prohibitively high costs of transition, the impact can be spread out over longer time periods.

Although reexamination is never easy, the effort is not without precedent. The federal government, in fact, has reexamined some of its programs and priorities episodically in the past. Programmatic reexaminations have included, for example, the 1983 Social Security reform, the 1986 tax reform, and the 1996 welfare reform. They have also included reforms such as the creation of the Department of Homeland Security and, most recently, the ongoing reorganization of the U.S. intelligence community. From a broader fiscal standpoint, the 1990s featured significant deficit-reduction measures adopted by the Congress and supported by the President that made important changes to discretionary spending, entitlement program growth, and revenues that helped eliminate deficits and bring about budgetary surpluses. States and other nations also have engaged in reexamination exercises.

In our system, a successful reexamination process will in all likelihood rely on multiple approaches over a period of years. The reauthorization, appropriations, oversight, and budget processes have all been used to review existing programs and policies. Adding other specific approaches and processes—such as temporary commissions to develop policy alternatives—has been proposed.

Fortunately the Government Performance and Results Act (GPRA) of 1993 and other result-oriented management laws enacted over the last 12 years

have built a base of performance information that can assist the Congress and the President in this effort. In the last few years, OMB has been working to rate the effectiveness of programs under the program assessment rating tool (PART). There are also many nongovernmental sources of program evaluation and analysis. And, finally, Congress has its own analytic support—your staff and that of the Congressional support agencies. As always, GAO stands ready to assist the Congress as it develops its agenda and to help answer any of the questions the Congress wishes to pursue.

Mr. Chairman, Senator Conrad, and Members of the Committee this concludes my testimony. I would be happy to answer any questions you may have.

Chairman GREGG. The Committee is adjourned.

[Whereupon, at 11:33 a.m., the Committee was adjourned.]

# THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL

**WEDNESDAY, FEBRUARY 9, 2005**

U.S. SENATE,
COMMITTEE ON THE BUDGET,
*Washington, DC.*

The committee met, pursuant to notice, at 10 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Domenici, Allard, Sessions, Bunning, Crapo, Ensign, Cornyn, Alexander, Conrad, Sarbanes, Murray, Wyden, Feingold, Stabenow, and Corzine.

Staff present: Scott B. Gudes, Majority Staff Director; and David Pappone.

Mary Ann Naylor, Staff Director; and Sue Nelson.

## OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will get started. It is 10 o'clock.

We very much appreciate the Director of the Office of Management and Budget for participating here for this hearing today, which is a hearing on the President's proposed budget, which becomes, as I describe it, the memo that controls the meeting, so to say. Actually, I should footnote that. That was Henry Kissinger's term.

In any event, the administration has sent us a budget which I believe sets out some fairly aggressive and appropriate fiscal initiatives in the area of trying to control our deficits. We all know that the deficit is too high and that we need to have action on the deficit. We also know that this divides into two issues: the short-term deficit and the long-term structural problems of our Government.

The short-term deficit, of course, is the fact that we are running very large numbers in deficit right now, and the President's budget has suggested ways we can reduce that in half over the next 4 to 5 years. And that is a very positive step, and he has done that through basically, as I have called it, goring everybody's ox. Everybody sort of takes a hit in this budget, which has not made anybody happy, which is probably a sign that it is a good budget.

The second issue of the structural deficit involves the fact that we have this demographic shift in our society which we cannot deny, as we all exist, and which is going to put huge pressures on our society as the baby-boom generation retires. Essentially, my generation, the baby-boom generation, is going to end up requiring of our children and our children's children significant support, which will translate into taxes on their earnings, which will trans-

late into a reduction of their quality of lifestyle, unless we address the retirement benefit structure for my generation so that it is affordable for our children and effective in the way that it covers people who are retired, especially low-income and middle-income seniors.

The President has stepped forward on that issue, both in his suggestion that we address the issue of Social Security and in the budget itself and his suggestions on Medicaid, which is one of the big items in the issue of long-term structural concern for the Government.

I have said all along that you cannot get to where we need to go in getting the deficit under control unless you address entitlement spending. This administration, with the exception of one item, which I am sure there will be some discussion about, has stepped forward on the entitlement accounts and made very strong proposals, proposals which I believe are appropriate and timely in Medicaid, in agriculture, and in a variety of other entitlement accounts.

So as a general statement, I congratulate the administration's initiative here. It is a document that the Congress is obviously going to work over because that is why we are here, as the administration knows. But in the end I hope that we can conclude that we will agree to the basic goals here, which are to control discretionary spending aggressively, especially nondefense discretionary, to pay for the war, but to also make sure that we do it in a responsible way that does not allow the defense base to overwhelm us, and to look at the entitlement accounts and make sure that we are fiscally responsible there—all of which will lead us toward reducing this deficit in half over the next 4 years, and in the out-years addressing the long-term concerns we have with entitlement spending.

So I thank the Director for being here. I thank him for his document, which is a well-prepared and well-thought-out and aggressive approach toward fiscal responsibility, and I yield to the Ranking Member, Senator Conrad.

## OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. I thank the chairman. I do not think it will come as a surprise to you that I have a somewhat different take on this budget.

First of all, let me say I welcome you, Mr. Director. I enjoyed our conversation the other day. I want to stipulate right at the beginning that I think you are a fine public servant. In many ways, the country is fortunate to have people of your quality who are willing to step forward in public service.

With that said, I think this budget——

Chairman GREGG. Is that the end of the kindness? Is that all the love we are going to feel here?

[Laughter.]

Senator CONRAD. It is kind of a wind-up. You know these baseball metaphors, Mr. Chairman.

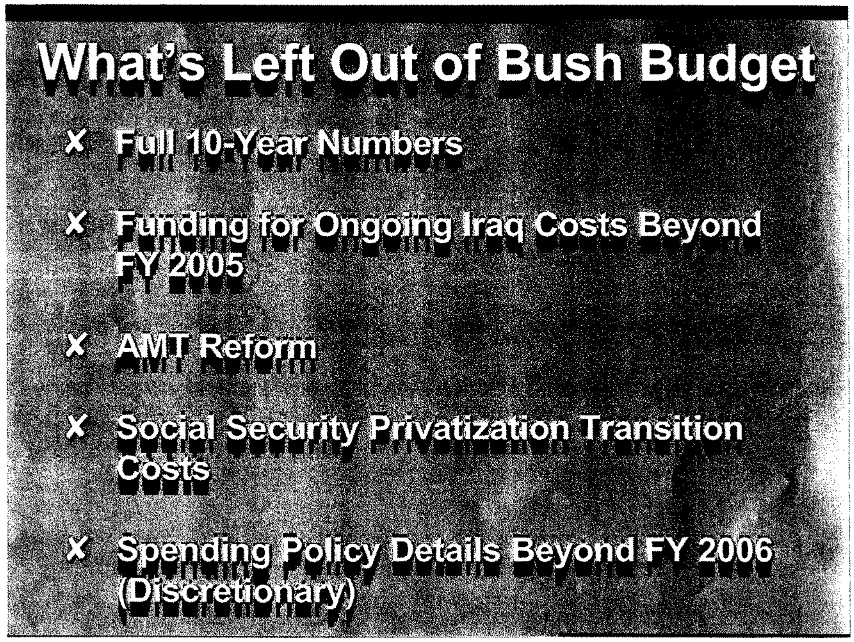
Seriously, I say to you I have been here 19 years, and I think this budget is completely off track. I believe that very genuinely. I have to say to you I think this is not so much a budget, it really

strikes me more as camouflage, because I think it is hiding the true fiscal condition of the country from the American people and even from Congress. Maybe this administration is even fooling themselves.

Let me go directly to some slides to make my point. You have a budget here that shows progress on the deficit, but as I see it, the only way it makes progress is it just leaves out things. It leaves out the funding for the ongoing war costs beyond September 30th of this year.

Now, the President says he has no timetable for withdrawal, but this budget provides a timetable. It says they are not going to spend anything on Iraq past September 30th of this year. Now, that is not credible.

It says that there is no cost to the President's privatization plans for Social Security. We all know that is not true. There is a massive cost, over $700 billion the first 10 years, according to the administration's estimates, but you cannot find that anywhere in this budget.

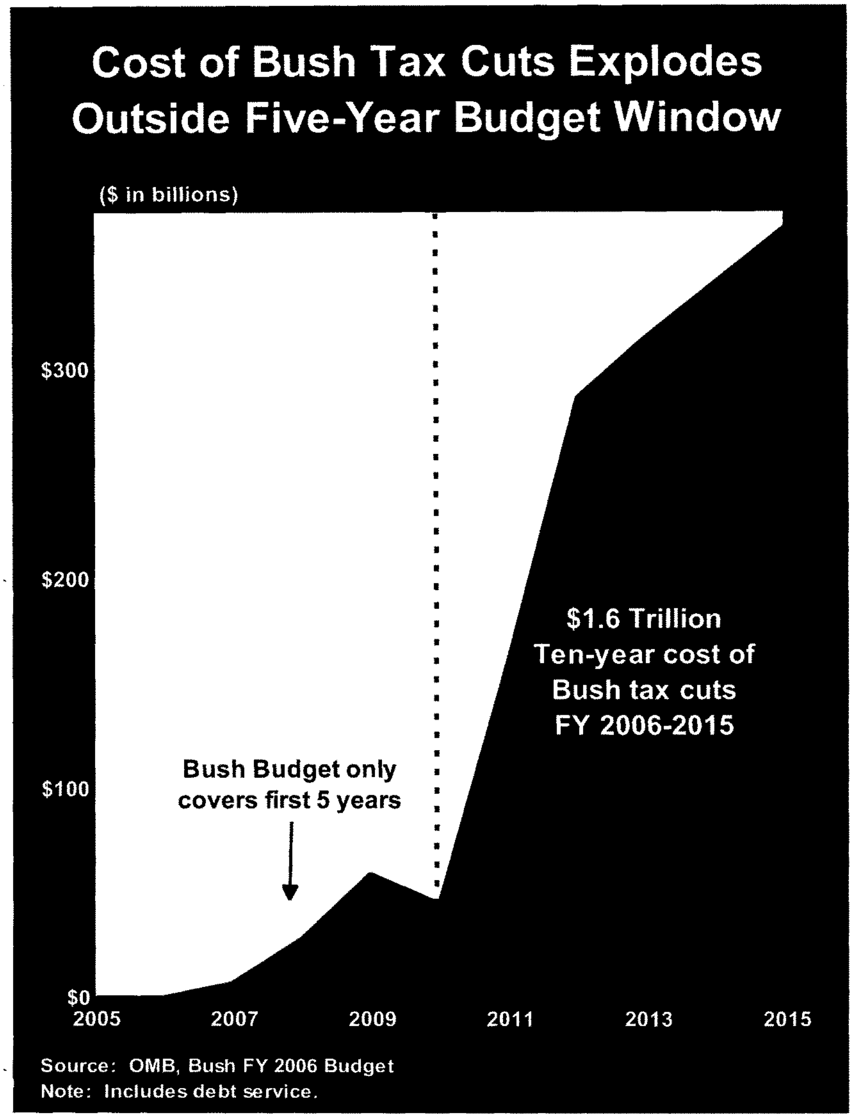

What's Left Out of Bush Budget
✗ Full 10-Year Numbers
✗ Funding for Ongoing Iraq Costs Beyond FY 2005
✗ AMT Reform
✗ Social Security Privatization Transition Costs
✗ Spending Policy Details Beyond FY 2006 (Discretionary)

Alternative minimum tax reform. Last year they at least provided funding for 1 year. The old millionaire's tax that is rapidly becoming a middle-class tax trap costs $700 billion to fix over 10 years. There is not a dime in the President's budget.

And then on the spending side of the ledger, you provide only details for 2006, no details for future years. I think there is a reason for that, because it gets really ugly after this year, and in some accounts it gets ugly this year.

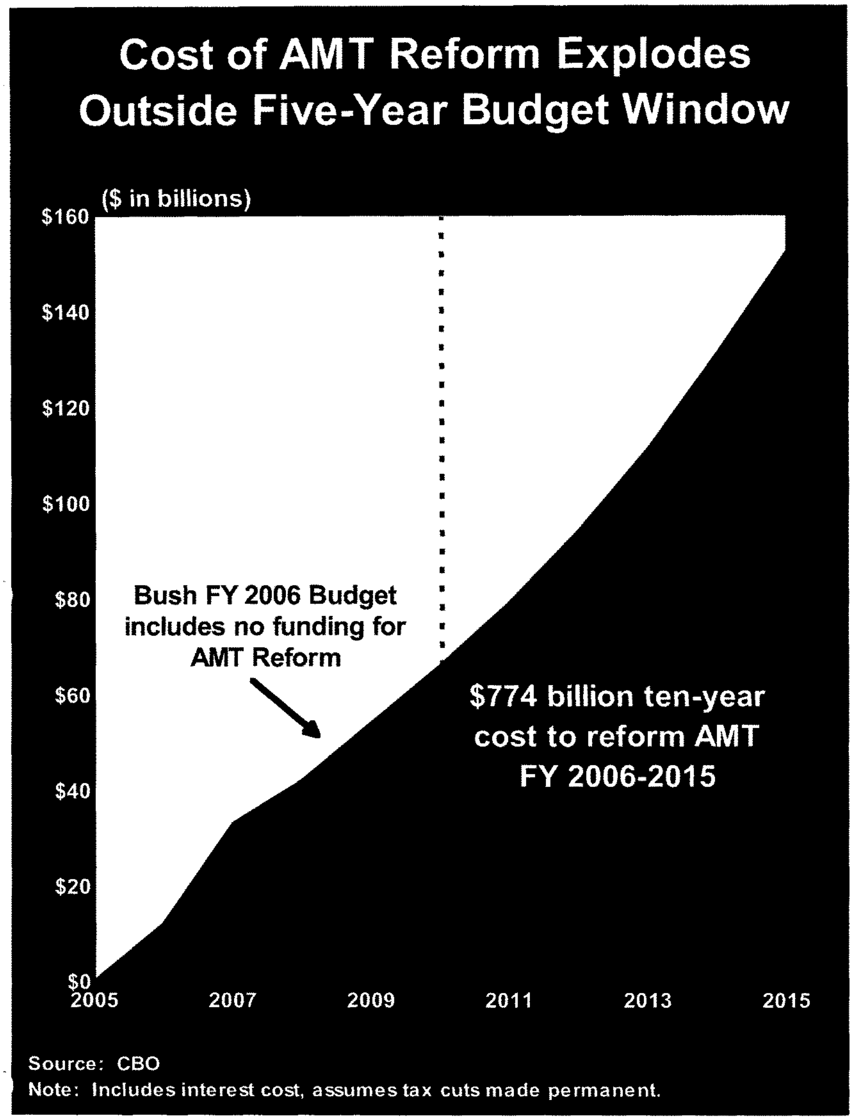
So as I look at this budget, I do not see a real fiscal plan for the country or something that really reveals the fiscal condition of the country. Instead, I see something that hides what I believe to be the true fiscal condition.

Let me go to the next chart.



Cost of Bush Tax Cuts Explodes
Outside Five-Year Budget Window
($ in billions)
$300
$200
$100
$0
2005
2007
2009
2011
2013
2015
Bush Budget only
covers first 5 years
$1.6 Trillion
Ten-year cost of
Bush tax cuts
FY 2006-2015
Source: OMB, Bush FY 2006 Budget
Note: Includes debt service.

The President reveals the effect of his budget proposal for just the first 5 years. But look what happens just beyond the budget window. The costs of the President's tax proposals explode. It is not surprising that you have gone from 10-year budgeting to 5-year budgeting, because you do not want Congress to see this and you do not want the American people to see this. But this is what happens. It is also the case with the alternative minimum tax where you have provided no funding in your budget. The Congressional Budget Office tells us this is the cost to deal with the alternative minimum tax, over $700 billion over the 10-year period. You cannot find it in the President's budget.



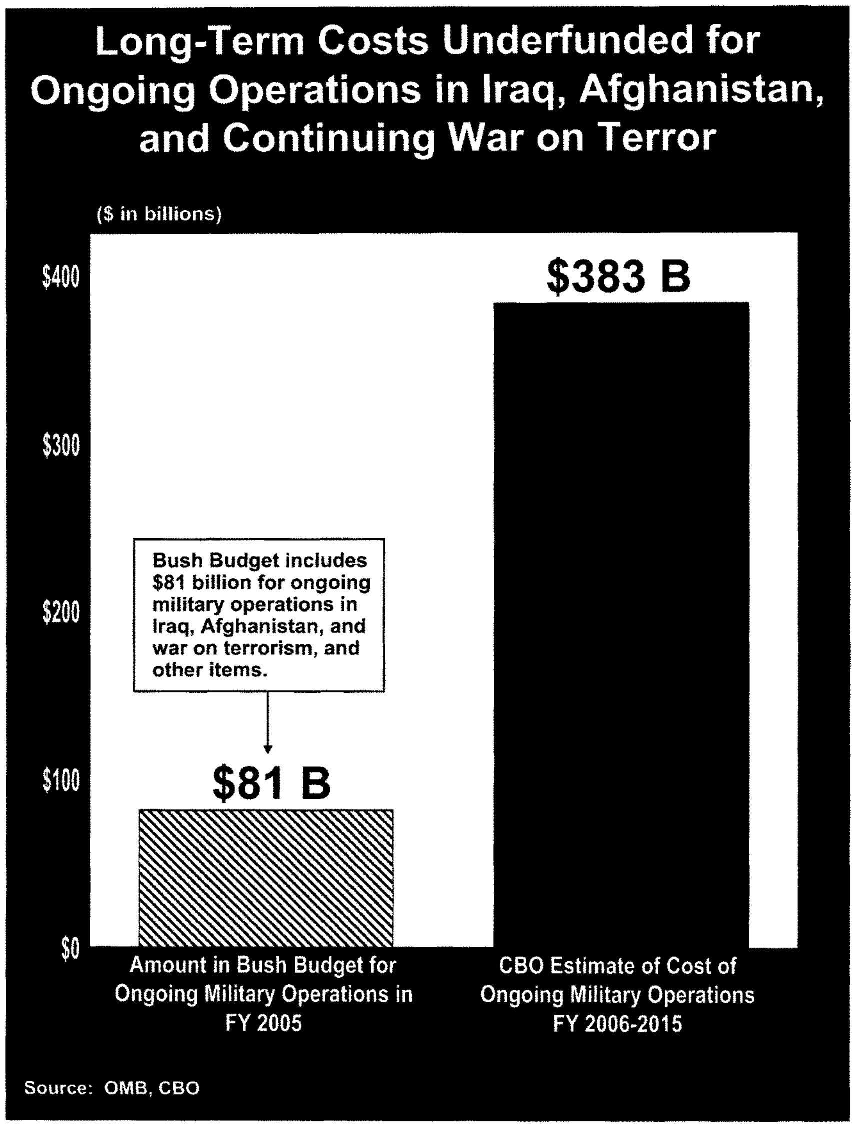
Cost of AMT Reform Explodes Outside Five-Year Budget Window
($ in billions)
$160
$140
$120
$100
$80
$60
$40
$20
$0
2005
2007
2009
2011
2013
2015
Bush FY 2006 Budget includes no funding for AMT Reform
$774 billion ten-year cost to reform AMT FY 2006-2015
Source: CBO
Note: Includes interest cost, assumes tax cuts made permanent.

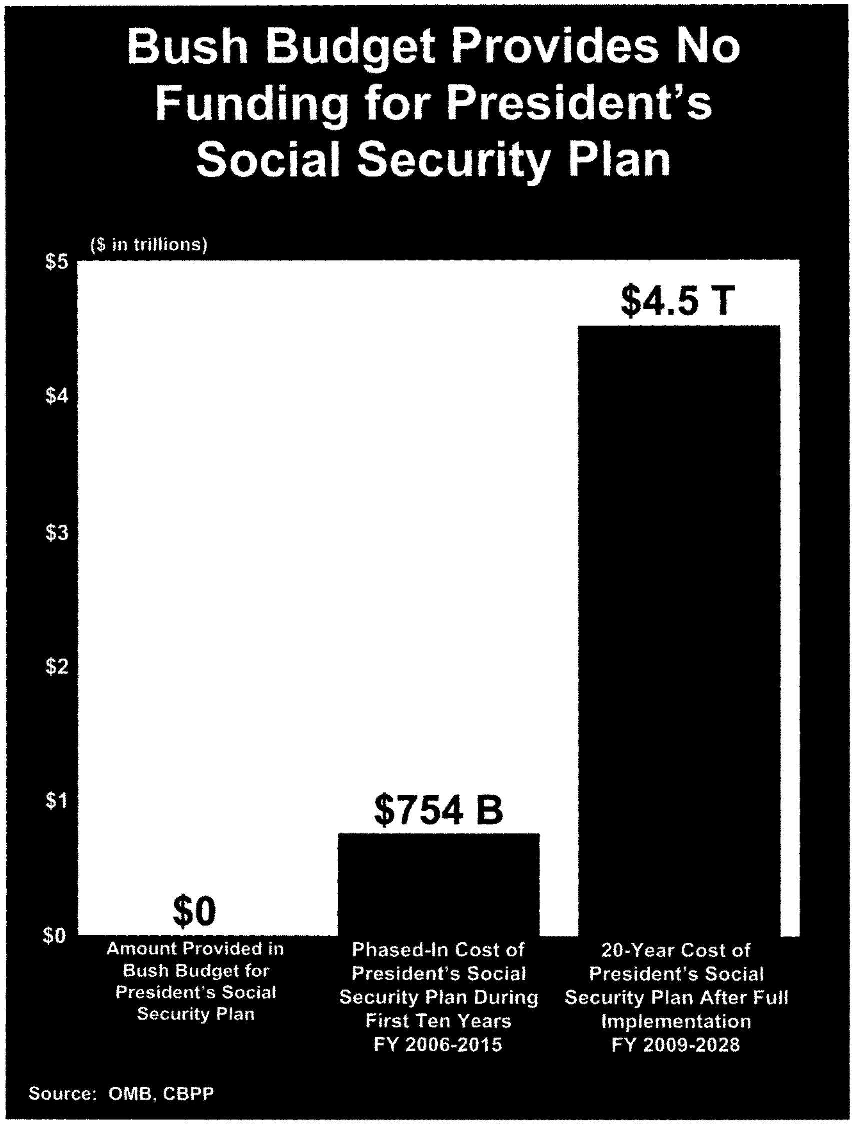
And why is that important? It is important because 3 million people are affected today. It is going to be 30 million people 10 years from now. Some are saying it may be 40 million people. The middle class is going to be in for a big surprise when they find themselves caught up in the alternative minimum tax.

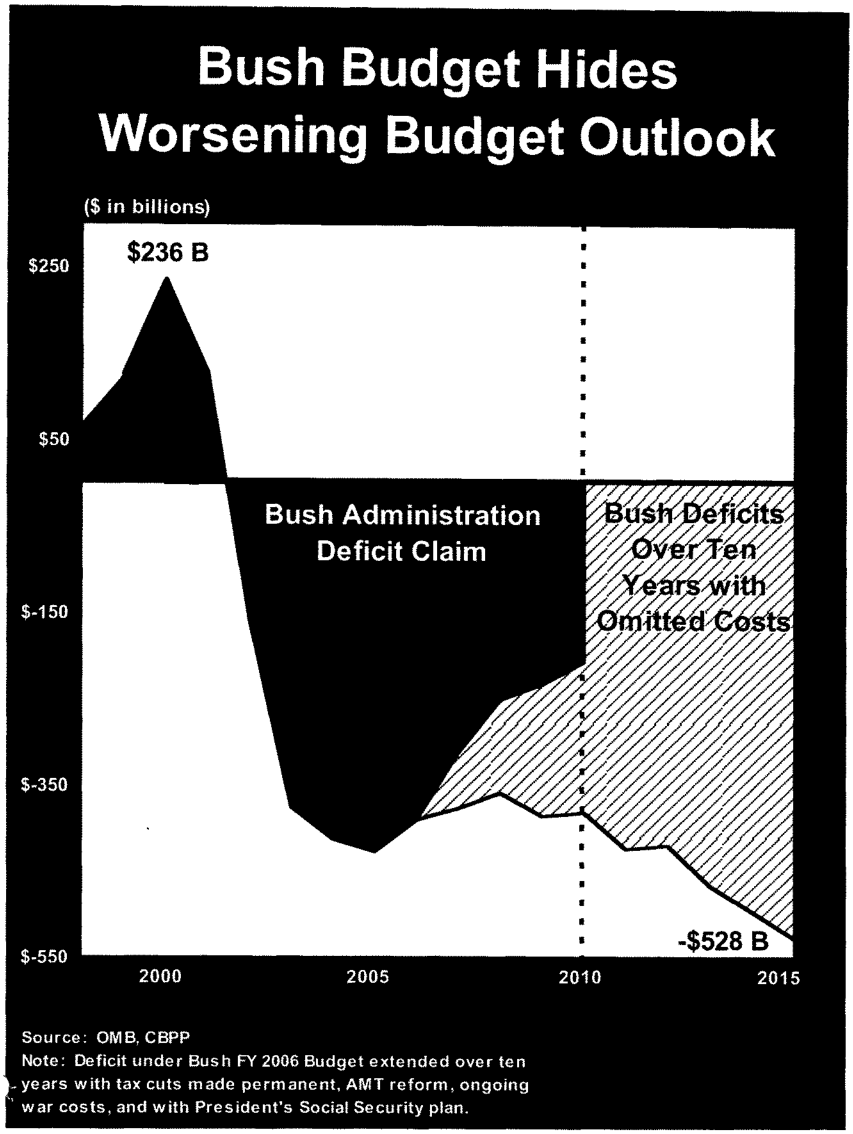
For the war, there is $81 billion in the budget, but there is nothing for it past September 30th. And I heard your testimony in other venues where you have said it is hard to estimate. That is what you told us last year. It is hard to estimate. The one thing we know for sure though is that the right answer is not zero. That is for sure not the right answer. The Congressional Budget Office says another $383 billion needs to be included in the budget to give a real reflection of the ongoing war cost.

On Social Security, the President has included nothing in terms of a cost for his privatization plan, but we know from the administration's own estimates that from 2006 to 2015, it costs $754 billion. The 20-year cost is a staggering $4.5 trillion. Now, you know, that is real money and it is not in the budget.

Let's go to the next.


Long-Term Costs Underfunded for Ongoing Operations in Iraq, Afghanistan, and Continuing War on Terror
($ in billions)
$400
$300
$200
$100
$0
$383 B
Bush Budget includes $81 billion for ongoing military operations in Iraq, Afghanistan, and war on terrorism, and other items.
$81 B
Amount in Bush Budget for Ongoing Military Operations in FY 2005
CBO Estimate of Cost of Ongoing Military Operations FY 2006-2015
Source: OMB, CBO


Bush Budget Provides No Funding for President's Social Security Plan
($ in trillions)
$5
$4
$3
$2
$1
$0
$4.5 T
$754 B
$0
Amount Provided in Bush Budget for President's Social Security Plan
Phased-In Cost of President's Social Security Plan During First Ten Years FY 2006-2015
20-Year Cost of President's Social Security Plan After Full Implementation FY 2009-2028
Source: OMB, CBPP

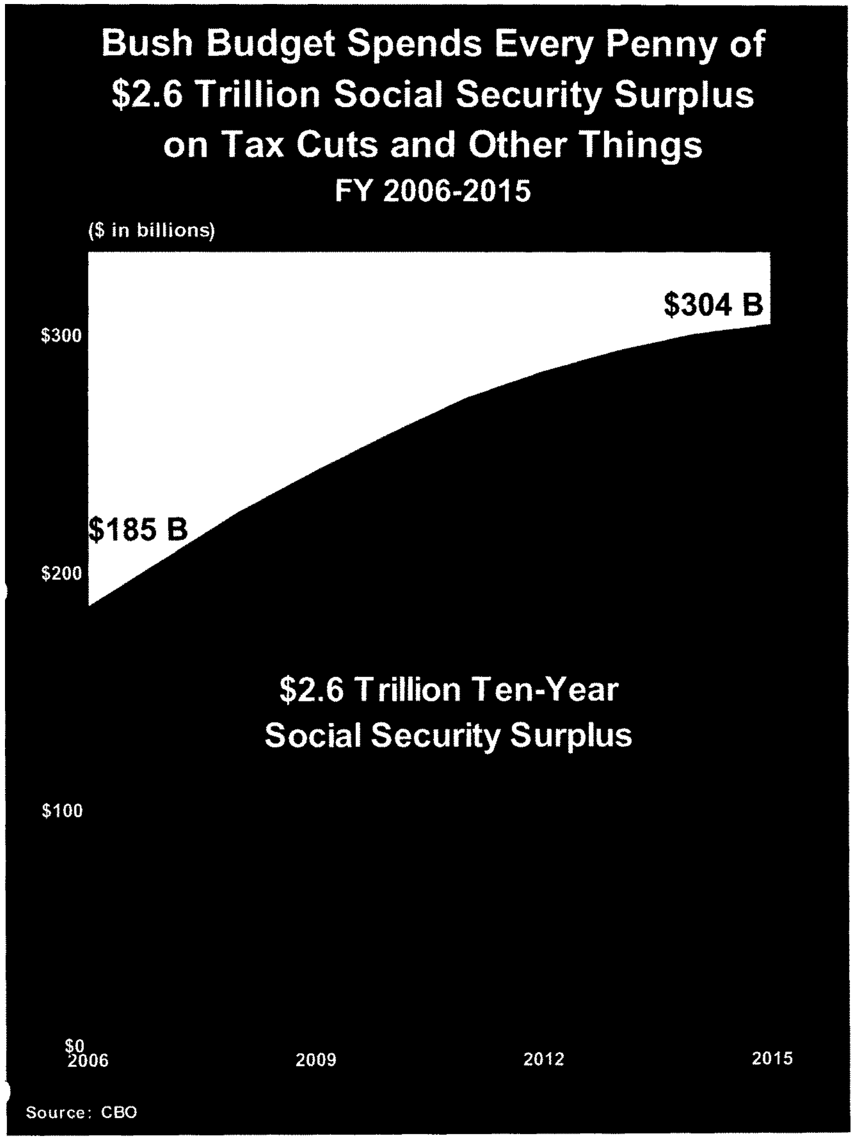

Bush Budget Hides
Worsening Budget Outlook
($ in billions)
$250
$50
$-150
$-350
$-550
$236 B
Bush Administration
Deficit Claim
Bush Deficits
Over Ten
Years with
Omitted Costs
-$528 B
2000
2005
2010
2015
Source: OMB, CBPP
Note: Deficit under Bush FY 2006 Budget extended over ten years with tax cuts made permanent, AMT reform, ongoing war costs, and with President's Social Security plan.

When we put back all of the things you have left out, here is what we see. This black line is the administration's claim that the deficit is going to be improving. This red box represents the administration's claim about improvement in the deficit. When we add back the things that are left out, here is what we see. We see a very modest improvement in the coming few years, but then things get much worse. I think an honest reflection of this budget would tell the American people that the fiscal condition gets much worse, if the President's plans are adopted and at the worst possible time, right before the baby boomers retire.

Finally, the President has said that Social Security is in crisis. But if you look at his budget, he is taking $2.6 trillion from Social Security over the next 10 years to pay for other things. If it is in crisis, why is he taking money raised by payroll taxes, designed to strengthen Social Security, by either paying down the debt or prepaying the liability? The President takes every dime of surplus Social Security money and uses it to pay for other things.

There is some disconnect between his language that there is a crisis in Social Security and his budget that takes all of the money that is available in Social Security that could be used to prepay the liability or pay down debt. He is taking $2.6 trillion over the next 10 years to pay for other things.

Finally, the Washington Post this morning now that says the drug benefit, instead of costing $400 billion, could cost as much as $1.3 trillion over the next 10 years. Now, in this story, I think in fairness, the Medicare chief, Mr. McClellan, said that there are various offsets and savings that will reduce the bottom-line costs to $724 billion. But we were told by this administration that was going to cost $400 billion. Now the administration is saying, oops, it is not $400 billion, it is not the $534 billion that we were told right after it passed, but instead $724 billion, and in gross terms potentially $1.2 trillion.


Bush Budget Spends Every Penny of
$2.6 Trillion Social Security Surplus
on Tax Cuts and Other Things
FY 2006-2015
($ in billions)
$304 B
$185 B
$2.6 Trillion Ten-Year
Social Security Surplus
$300
$200
$100
$0
2006
2009
2012
2015
Source: CBO

Let me just say that this new information damages the credibility of this administration in a very serious way with respect to the rest of their budget proposal because there is a pattern here. There is a pattern of concealing, the true fiscal condition of the country from the Congress and from the American people.

I thank the Chair.

Chairman GREGG. Thank you. We are going to subscribe to the 5-minute rule here. Unfortunately, the Director has to go over to the House and testify after he comes here, which is an unfortunate experience for you. But we do want to give people the opportunity to speak to you and ask you questions.

Let's start with this Medicare number, the drug number, which has become the cause du jour. And I would be interested in your thoughts on the story in the Washington Post, which says it is a $1.2 trillion number over the next 10 years as versus what I would guess would be a $720 billion number if we were talking apples to apples in the 10 years comparing the—in other words, the $400 billion number was for 2 years' startup, 2004 to 2014. This number of 1.2, I guess is from 2006 to 2015. If you compare 2006 to 2015 under the projected numbers, I presume the number we are dealing with is 700-something.

What is the actual increase in the drug benefit cost over the original estimate? is the question.

**STATEMENT OF HON. JOSHUA B. BOLTEN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET**

Mr. BOLTEN. Mr. Chairman, thank you, and thank you for the nice welcome, and Senator Conrad as well, other members.

Mr. Chairman, I have a compelling opening statement that I would like to have included in the record.

Chairman GREGG. I apologize for skipping your opening statement.

[Laughter.]

Chairman GREGG. This issue interests me so much, I wanted to get to it.

Mr. BOLTEN. All right, sir.

Chairman GREGG. So let me withdraw my question, save it for you, know that you will answer it in your opening statement, and allow you to make your opening statement.

Mr. BOLTEN. Mr. Chairman, if you prefer, I will skip the opening statement.

Chairman GREGG. No. I think you should make it because I think that you have a good case, and I think the Senator from North Dakota has made a case, I have made a case, and we would like to hear your case. So we definitely want to hear your opening statement.

Mr. BOLTEN. I hope you will find it compelling, Mr. Chairman, and thank you, Senator Conrad and other members of the committee, for your welcome.

The President's budget, which was transmitted on Monday to the Congress, meets the priorities of the Nation and builds on the progress of the last 4 years.

We are funding our efforts to defend the homeland from attack. We are transforming our military and supporting our troops as

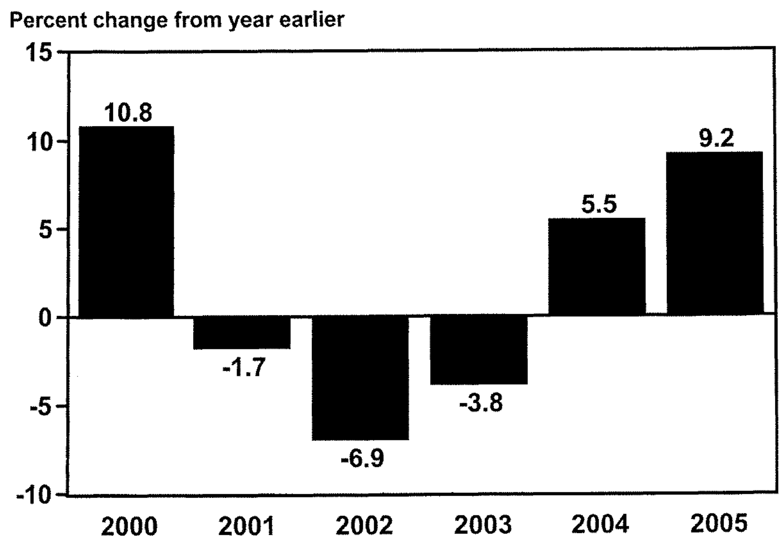
they fight and win the global war on terror. We are helping to spread freedom throughout the world. We are promoting the pro-growth policies that have helped produce millions of new jobs and restore confidence in the economy.

Over the past 4 years, the President and Congress rose to meet historic challenges: a collapsing stock market, a recession, the revelation of corporate scandals, and, of course, the terrorist attacks of September 11th.

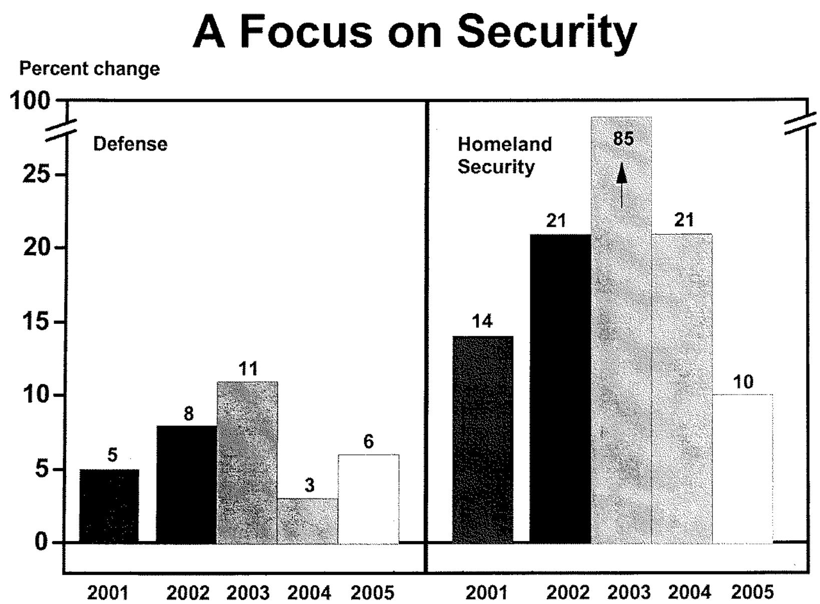
To meet the economy's significant challenges, in each year of the first term Congress and the President enacted major tax relief that fueled recovery, business investment, and job creation.

The strong economic growth unleashed by tax relief is reflected in this chart. Since the recession year of 2001, economic growth has increased in each of the following 3 years. A primary goal of the budget that we have just sent up is to assure that our economic growth continues.

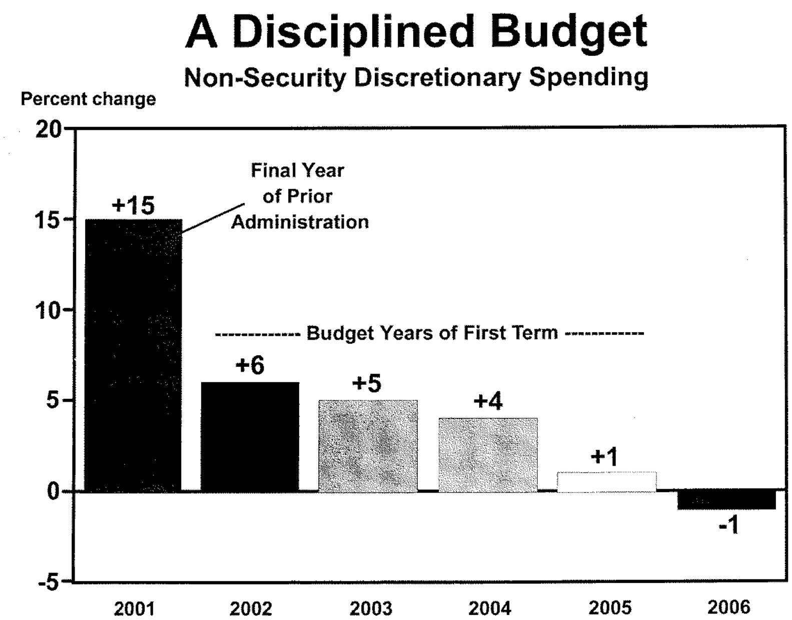
## Recovering Economy = Rising Receipts



Now we can take the next chart. A strengthening economy produces rising tax revenues. Last year, after declining 3 years in a row, Federal revenues grew by nearly $100 billion. Reflecting strong continued growth, we project that Federal revenues will grow by an even larger figure this year.


A Focus on Security
Percent change
100
25
20
15
10
5
0
Defense
5
8
11
3
6
Homeland
Security
14
21
85
21
10
2001
2002
2003
2004
2005
2001
2002
2003
2004
2005

The President and Congress have also devoted significant resources to rebuild and transform our military and to protect our homeland. In the first term, the defense budget grew by more than a third, the largest increase since the Reagan administration, can we see the next chart. To make our homeland safer, the President worked with Congress to create the Department of Homeland Security and nearly tripled funding for homeland security government-wide.

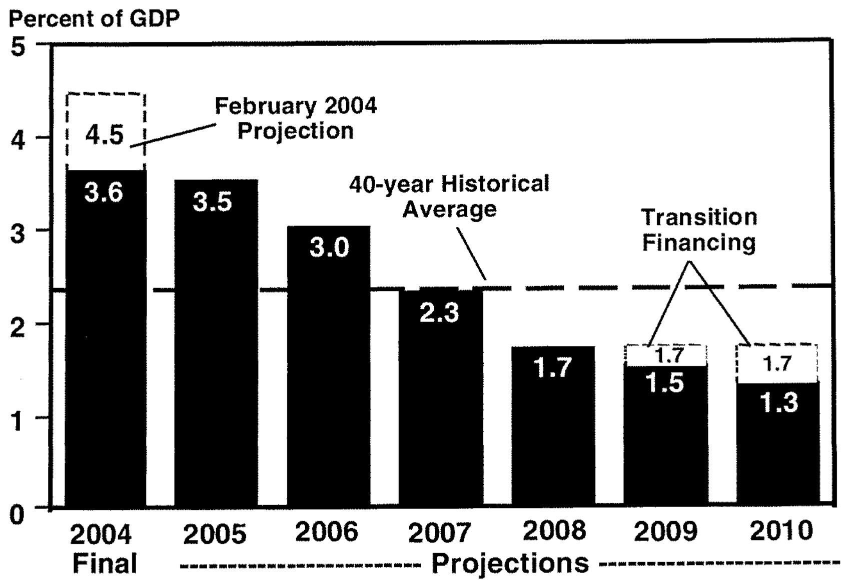

A Disciplined Budget
Non-Security Discretionary Spending
Percent change
20
15
10
5
0
-5
+15
Final Year
of Prior
Administration
------------- Budget Years of First Term ------------
+6
+5
+4
+1
-1
2001
2002
2003
2004
2005
2006

While committing these necessary resources to protecting America, the President and Congress have focused on spending restraint elsewhere in the budget. Working together, we have succeeded in bringing down the rate of growth in non-security discretionary spending each year of the President's first term. In the last budget year of the previous administration, non-security discretionary spending grew by 15 percent as represented by the green bar. In 2005, such spending will rise by about only 1 percent. Because of this increased spending restraint, deficits are below what they otherwise would have been.

In order to sustain our economic expansion, we must exercise even greater spending restraint than in the past. When the Federal Government focuses on its priorities and limits the resources it takes from the private sector, the result is a stronger, more productive economy.

The President's 2006 budget proposals build on that enhanced restraint. As you can see from this chart, the 2006 budget proposes a reduction in the non-security discretionary spending category of the budget. This is the first proposed cut in the non-security spending category since the Reagan administration.

# Cutting the Deficit



The budget proposes more than 150 reductions, reforms, and eliminations in nondefense discretionary programs, which save about $20 billion in 2006 alone.

As a result of this enhanced restraint, overall discretionary spending, even after significant increases in defense and homeland security, will grow by only 2.1 percent. That is less than the projected rate of inflation of about 2.3 percent. In other words, under the President's 2006 budget, overall discretionary spending will see a reduction in real terms.

The budget also proposes savings from an additional set of reforms in mandatory programs, which save about $137 billion over the next 10 years.

As this committee well knows, both mandatory and discretionary categories of spending are inherently difficult to control, but mandatory programs are especially difficult because of their auto-pilot feature. The administration looks forward to working with this committee and the rest of the Congress on a package of mandatory savings.

We will also work with Congress on budget process reforms. Last year, I transmitted to Congress, on behalf of the administration, proposed legislation to establish statutory budget enforcement controls. We will have similar proposals this year.

In addition, the administration proposes other enforcement and budget process reforms, such as the line-item veto, a Results Commission, and a Sunset Commission. These reforms would put in place the tools we need to enforce spending restraint and would bring greater accountability and transparency to the budgeting process.

The budget restrains spending in a responsible way by focusing on priorities, principles, and performance. We were guided by three major criteria in evaluating programs:

First, does the program meet the Nation's priorities?

Second, does the program meet the President's principles for the use of taxpayer resources?

Third, does the program produce the intended results?

The Bush administration is comprehensively measuring the effectiveness of the Government's programs, and the results are helping us make budgeting decisions. As part of the President's Management Agenda, the Program Assessment Rating Tool, or PART, for those who are cognoscenti of these management tools, was developed to measure the performance of Federal programs. Roughly 60 percent of all Federal programs have undergone the PART, and those scores figured into our budgeting process.

By holding Government spending to these accountability standards, by focusing on our priorities, and by maintaining pro-growth economic policies, we are making progress in bringing down the size of the deficit in 2006 and beyond.

Last year's budget initially projected a deficit of 4.5 percent of GDP in 2004, or $521 billion. The President set out to cut this deficit in half by 2009. Largely because economic growth generated stronger revenues than originally estimated, and because the Congress delivered the spending restraint called for by the President, the 2004 deficit came in $109 billion lower than originally estimated.

At 3.6 percent of GDP—that is the figure in the far dark-blue column on the left—the actual 2004 deficit, while still too large, was well within historical range and smaller than the deficits in 9 of the last 25 years.

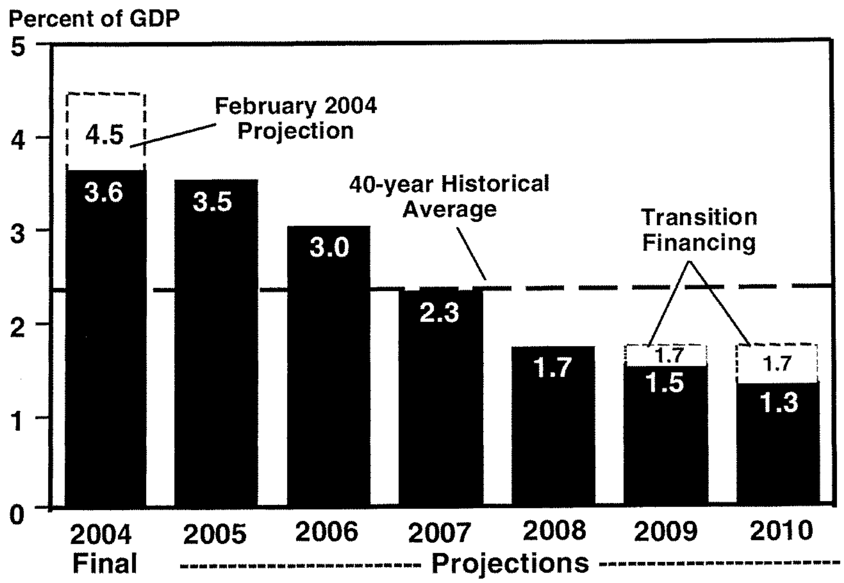
We project the 2005 deficit to come in at 3.5 percent of GDP or $427 billion. If we maintain the policies of economic growth and spending restraint reflected in this budget, the deficit is expected to decline in 2006 and each of the next 4 years. In 2006, we project the budget deficit to decline to 3.0 percent of GDP. In 2007, the deficit is projected to fall further to 2.3 percent of GDP.

By 2009, the deficit is projected to be cut by more than half from its originally estimated 2004 peak, to just 1.5 percent of GDP, which is well below the 40-year historical average deficit of 2.3 percent of GDP, and lower than the deficit level in all but 7 of the last 25 years.

The administration intends to submit shortly a supplemental appropriations request of approximately $81 billion, primarily to support operations in Iraq and Afghanistan for the remainder of the fiscal year. The 2006 budget spending and deficit projections fully reflect the outlay effects of this supplemental request, as well as the prior $25 billion supplemental bill already enacted by the Congress. However, the budget does not reflect the effect of undetermined but anticipated supplemental requests for ongoing operations in Iraq and Afghanistan beyond 2006.

The published version of the 2006 budget also does not reflect the effects of transition financing associated with the President's proposals to create personal retirement accounts as part of a comprehensive plan to fix Social Security. As the administration announced last week, the type of personal accounts the President is proposing will require approximately $664 billion in transition financing over the next 10 years, with an additional $90 billion in related debt service. This transition financing would result in a deficit in 2009 and 2010 of 1.7 percent of GDP. Let's see that on the chart. Those levels are still consistent with the President's goal to cut the deficit in half by 2009 and still well below the 40-year historical average deficit.

# Cutting the Deficit



It is important to remember that this transition financing does not have the same impact on national savings, and thus on the economy, as does traditional borrowing. Every dollar the Government borrows to fund the transition to personal accounts is fully offset by an increase in savings represented by the accounts themselves. In addition, the transition financing of retirement benefits does not represent new debt. These are obligations that the Government already owes in the form of future benefits.

Perhaps most important, comprehensive Social Security reform that includes personal accounts can eliminate the system's current $10.4 trillion in unfunded obligations.

Senator SARBANES. Mr. Bolten, could you pull that microphone closer to you? I think it would be helpful. If you keep it too far away, we do not pick up your voice.

Mr. BOLTEN. Am I doing better now?

Senator SARBANES. That is better.

Mr. BOLTEN. Those of us who devote our time to thinking about fiscal policy all share a common interest in averting this danger. There is no task as vital to fiscal policymakers this year than removing these unfunded obligations by enacting comprehensive Social Security reform.

Confronting these long-term obligations, combined with our near-term deficit reduction efforts, will help assure a strong economy both now and in the future.

I look forward to working with the committee and Congress on this budget, which meets the priorities of the Nation in a fiscally responsible way.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Mr. Director, and I apologize again for skipping over that. It was a good point, and a couple points which I would just pick up on is that to the extent that we reflect these transition costs, the deficit will still be going down by half, and the issue of Social Security. But the most important point is that if we reform Social Security, in the out-years we will have a $10 trillion essentially correction occurring in the fiscal situation of the Federal Government in that we will be able to, instead of facing massive deficits in the out-years in Social Security, actually have a fund that is solvent.

Unfortunately, the budget process by definition does not really structure itself to address Social Security, and that is why we are out of the process, because we are a 5-year budget, and Social Security is a lifetime-of-earning issue, which is a 30-, 40-year experience. And so if you are going to adequately reflect Social Security and if you make changes in Social Security, you really need to see what the 30-year impact is, not put it in a 5-year window because that really perverts the answer, which is an excellent point that you have made.

Let me put two questions on the table. The first is the question which was raised by Senator Conrad, which is the question of what is the number for the drug benefit in relationship to the number that was estimated? How much higher it? Is this $1.2 trillion number an accurate apples-to-apples comparison? And what is in that number, if you know?

Second—well, why don't we answer that question first, and then I will get into my second question.

Mr. BOLTEN. Mr. Chairman, thank you. It is not an accurate apples-to-apples comparison. This has come up just recently, so I would like to have the opportunity to submit something more detailed, perhaps from Dr. McClellan, for the record. But your description was exactly right, which is that our estimates, I think, remain in exactly the same range that they have been. In fact, I think our estimates in this budget for Medicare costs may have come down slightly from the estimates we put out 6 months ago.

**Medicare Modernization Act Cost Estimates**

The Office of the Actuary at the Centers for Medicare and Medicaid Services (OACT) originally estimated the total net cost of the new Medicare drug benefit at $511 billion for the ten-year window of fiscal years 2004-2013.

OACT recently re-estimated the cost of the drug benefit, both for the 2004-2013 period and the FY 2006-2015 budget window. OACT's current estimate of the FY 2004-2013 cost is very similar to its original estimate: they found the FY 2004-2013 net cost to be an estimated $518 billion. The net cost from FY 2006-2015 is estimated to be $724 billion.

The table below lays out the original MMA estimates and current estimates for the FY 2004-2013 and FY 2006-2015 budget windows:

**Medicare Prescription Drug Benefit Outlays**
**Comparison of MMA Scoring to 2006 President's Budget Estimates**
**($ in billions)**

| | MMA Estimates | FY 2006 PB Estimates | |
|---|---|---|---|
| | **2004-2013** | **2004-2013** | **2006-2015** |
| Gross benefit outlays | 820 | 849 | 1,192 |
| Premium receipts | -102 | -102 | -145 |
| Receipts from States | -85 | -97 | -134 |
| Net Medicare Rx outlays | 634 | 650 | 913 |
| Net Medicaid cost | -123 | -132 | -189 |
| **Net Rx benefit outlays** | **511** | **518** | **724** |

Source: CMS, Office of the Actuary

**Medicaid Current Law and Proposed Law, FY 2006 Budget**

| | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 | 2006-2010 | 2006-2015 | Ten-year Growth Rates |
|---|---|---|---|---|---|---|---|---|---|
| Medicaid Baseline | 188.3 | 192.6 | 205.2 | 223.5 | 243.8 | 265.4 | 1,130.4 | 2,820.5 | 7.6% |
| Medicaid Legislative Proposals | 0.2 | 0.3 | (2.4) | (3.6) | (3.9) | (4.2) | (13.7) | (45.0) | |
| Medicaid Proposed Law | 188.5 | 192.9 | 202.8 | 219.9 | 239.9 | 261.2 | 1,116.7 | 2,775.6 | 7.3% |

Please note: The combined Medicaid/SCHIP current law growth rate is 7.4 percent. If Medicaid is considered independent of SCHIP, the current law growth rate would be 7.6 percent (as reflected above). Likewise, the combined Medicaid/SCHIP proposed law growth rate is 7.2 percent. If Medicaid is considered independent of SCHIP, the proposed law growth rate would be 7.3 percent (as reflected above).

**Medicaid and SCHIP Growth Rates, FY 2006-FY 2015**

| | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 | 2006-2010 | 2006-2015 | Ten-year Growth Rates |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Medicaid Baseline | 188.3 | 192.6 | 205.2 | 223.5 | 243.8 | 265.4 | 288.2 | 312.1 | 336.9 | 362.9 | 390.0 | 1,130.4 | 2,820.5 | 7.6% |
| SCHIP Baseline | 5.3 | 5.4 | 5.4 | 5.3 | 5.3 | 5.4 | 5.5 | 5.4 | 5.3 | 5.3 | 5.1 | 26.8 | 53.4 | |
| Total, Medicaid/SCHIP | 193.6 | 198.0 | 210.6 | 228.8 | 249.0 | 270.8 | 293.7 | 317.6 | 342.2 | 368.1 | 395.1 | 1,157.2 | 2,873.9 | 7.4% |
| Medicaid Legislative Proposals | 0.2 | 0.3 | (2.4) | (3.6) | (3.9) | (4.2) | (4.8) | (5.4) | (6.2) | (6.9) | (7.9) | (13.7) | (45.0) | |
| SCHIP Legislative Proposals | - | 0.8 | 0.9 | (0.1) | (0.3) | (0.2) | (0.3) | (0.1) | (0.1) | (0.1) | (0.0) | 1.0 | 0.4 | |
| Medicaid Proposed Law | 188.5 | 192.9 | 202.8 | 219.9 | 239.9 | 261.2 | 283.4 | 306.7 | 330.7 | 356.0 | 382.0 | 1,116.7 | 2,775.6 | 7.3% |
| Medicaid/SCHIP Proposed Law | 193.8 | 199.1 | 209.1 | 225.1 | 244.8 | 266.4 | 288.5 | 312.0 | 335.9 | 361.2 | 387.2 | 1,144.5 | 2,829.3 | 7.2% |

The reason it is not an apples-to-apples comparison is that when you were considering the Medicare bill, there were a wide variety of offsets that were not considered. I have a list of some of them here: that States are now contributing to the cost of the benefit, that is about $134 billion; beneficiary premiums are adding about $145 billion. The number that was cited in the newspaper does not take into account that the Federal Government is saving almost $200 billion on Medicaid now because seniors are receiving their coverage through Medicare.

So all of those offsets bring the number down to the one that I think Dr. McClellan cited in the low $700 billion figure, and then a true apples-to-apples comparison would be over the same time period. When you were looking at the Medicare bill, the years covered were, I think, 2004 to 2013. That was the relevant 10-year period. Now the 10-year period is 2006 to 2015, as you identified. And when we make that shift of just 2 years in the 10-year period, what we are adding at the back end are years in which the drug benefit is fully phased in. So naturally those costs are going to be higher. And what we are dropping off are the early years of the 10-year Medicare plan in which the drug benefit was not fully phased in. We have had a drug card and so on, but the full Medicare benefit arises in 2006.

So if I may, I would like to submit something detailed for the record, responding on the numbers, but the short answer is that I think the numbers that are reflected in this budget are completely consistent with the numbers that the administration has produced before for the costs of the Medicare system.

Chairman GREGG. As you know, I am not a great defender of the drug benefit because it is scored to be about an $8 trillion unfunded liability over the next—over the actuarial life, which is 75 years, and I do think we are going to have to go back and readdress it. But I do think these numbers are misleading as they have been reported, and I think by saying that I might have more credibility than others because I would be the first to be aggressive were they not.

As I see it, basically what the 1.2 is, it has not netted out the income that will come in, which would be about $300 billion. So you are back down to about 900. And then it has not netted out the fact that you are moving $200 billion out of Medicaid over to Medicare, so that gets you down to the $700 billion. And as you mentioned, the out-years, as we hit the out-years, we are into full participation and your annual cost is about $138 billion a year as versus the 56 that it starts out at.

So that is where the numbers come from, as I see them, but I am still very suspect of this program as to its cost, and I certainly want to know what the real numbers are, and so we will look forward to getting more specifics.

What I would like to do is go on, though, to the other entitlement issues. In your budget submission, you propose a fair number of entitlement accounts which you wish to slow the rate of growth of, you do not cut any. And then there are a number of other issues where you actually create new entitlement accounts.

Could you give us a general statement of what accounts you are slowing the rate of growth in and what the number is, approxi-

mately, and then the accounts that you are adding and what the 5-year or 10-year number is?

Mr. BOLTEN. Mr. Chairman, again, I would like to submit something formal for the record that will put precise numbers on it. But we are proposing to slow the growth in the rate of Medicaid spending from about 7.4 percent per year to about 7.2 percent per year out over the next 10 years. The net savings in the Medicaid system would be about $45 billion over 10 years, and we are hoping to achieve that through program integrity measures. More importantly—and without reducing the actual service that we can provide to the lowest-income folks who depend on Medicaid.

**Medicare Modernization Act Cost Estimates**

The Office of the Actuary at the Centers for Medicare and Medicaid Services (OACT) originally estimated the total net cost of the new Medicare drug benefit at $511 billion for the ten-year window of fiscal years 2004-2013.

OACT recently re-estimated the cost of the drug benefit, both for the 2004-2013 period and the FY 2006-2015 budget window. OACT's current estimate of the FY 2004-2013 cost is very similar to its original estimate: they found the FY 2004-2013 net cost to be an estimated $518 billion. The net cost from FY 2006-2015 is estimated to be $724 billion.

The table below lays out the original MMA estimates and current estimates for the FY 2004-2013 and FY 2006-2015 budget windows:

**Medicare Prescription Drug Benefit Outlays**
**Comparison of MMA Scoring to 2006 President's Budget Estimates**
**($ in billions)**

| | **MMA Estimates** | **FY 2006 PB Estimates** | |
|---|---|---|---|
| | **2004-2013** | **2004-2013** | **2006-2015** |
| Gross benefit outlays | 820 | 849 | 1,192 |
| Premium receipts | -102 | -102 | -145 |
| Receipts from States | -85 | -97 | -134 |
| Net Medicare Rx outlays | 634 | 650 | 913 |
| Net Medicaid cost | -123 | -132 | -189 |
| **Net Rx benefit outlays** | **511** | **518** | **724** |

Source: CMS, Office of the Actuary

**Medicaid Current Law and Proposed Law, FY 2006 Budget**

| | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 | 2006-2010 | 2006-2015 | Ten-year Growth Rates |
|---|---|---|---|---|---|---|---|---|---|
| Medicaid Baseline | 188.3 | 192.6 | 205.2 | 223.5 | 243.8 | 265.4 | 1,130.4 | 2,820.5 | 7.6% |
| Medicaid Legislative Proposals | 0.2 | 0.3 | (2.4) | (3.6) | (3.9) | (4.2) | (13.7) | (45.0) | |
| Medicaid Proposed Law | 188.5 | 192.9 | 202.8 | 219.9 | 239.9 | 261.2 | 1,116.7 | 2,775.6 | 7.3% |

Please note: The combined Medicaid/SCHIP current law growth rate is 7.4 percent. If Medicaid is considered independent of SCHIP, the current law growth rate would be 7.6 percent (as reflected above). Likewise, the combined Medicaid/SCHIP proposed law growth rate is 7.2 percent. If Medicaid is considered independent of SCHIP, the proposed law growth rate would be 7.3 percent (as reflected above).

**Medicaid and SCHIP Growth Rates, FY 2006-FY 2015**

| | FY 2005 | FY 2006 | FY 2007 | FY 2008 | FY 2009 | FY 2010 | FY 2011 | FY 2012 | FY 2013 | FY 2014 | FY 2015 | 2006-2010 | 2006-2015 | Ten-year Growth Rates |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Medicaid Baseline | 188.3 | 192.6 | 205.2 | 223.5 | 243.8 | 265.4 | 288.2 | 312.1 | 336.9 | 362.9 | 390.0 | 1,130.4 | 2,820.5 | 7.6% |
| SCHIP Baseline | 5.3 | 5.4 | 5.4 | 5.3 | 5.3 | 5.4 | 5.5 | 5.4 | 5.3 | 5.3 | 5.1 | 26.8 | 53.4 | |
| Total, Medicaid/SCHIP | 193.6 | 198.0 | 210.6 | 228.8 | 249.0 | 270.8 | 293.7 | 317.6 | 342.2 | 368.1 | 395.1 | 1,157.2 | 2,873.9 | 7.4% |
| Medicaid Legislative Proposals | 0.2 | 0.3 | (2.4) | (3.6) | (3.9) | (4.2) | (4.8) | (5.4) | (6.2) | (6.9) | (7.9) | (13.7) | (45.0) | |
| SCHIP Legislative Proposals | - | 0.8 | 0.9 | (0.1) | (0.3) | (0.2) | (0.3) | (0.1) | (0.1) | (0.1) | (0.0) | 1.0 | 0.4 | |
| Medicaid Proposed Law | 188.5 | 192.9 | 202.8 | 219.9 | 239.9 | 261.2 | 283.4 | 306.7 | 330.7 | 356.0 | 382.0 | 1,116.7 | 2,775.6 | 7.3% |
| Medicaid/SCHIP Proposed Law | 193.8 | 199.1 | 209.1 | 225.1 | 244.8 | 266.4 | 288.5 | 312.0 | 335.9 | 361.2 | 387.2 | 1,144.5 | 2,829.3 | 7.2% |

The more important thing is that we are also proposing a comprehensive reform of the Medicaid system, which is very tied up and has a lot of structures in it to prevent Governors from using the funds appropriately. We can go into more detail on that. We are proposing a reduction in farm programs and farm subsidies of about $5.4 billion. I do not recall exactly what percentage decrease that is. I will ask my staff to help me out.

It is in the low single digits as a percentage of total projected farm spending that we are proposing to reduce—3.8 percent.

We are also proposing to increase—to capture some savings from power marketing authorities by asking them to charge a market rate for the electricity. Those are some of the largest elements. And then in addition, we are proposing to capture savings in the student loan programs by making it possible for the government to deliver some of the benefits, without the middleman in the process collecting quite as large a fee.

Chairman GREGG. And the new programs, new entitlement programs?

Mr. BOLTEN. We are continuing to carry a health credit in the budget, that is, a credit for the uninsured to purchase health insurance on their own. This is not new. This has been in our budgets in the past. But in terms of new entitlement spending, I think it is very restrained.

On the Medicaid side, we are proposing a program to sign up more kids for S-CHIP, which has been a relatively effective program, and there is about $1 billion of spending over the next 2 years to get more, more of the eligible kids signed up. But there is also an associated cost with that within the S-CHIP program, because as we sign up more eligible children, there will be more burden on the Federal budget, and we are carrying those costs as well in our budget.

Chairman GREGG. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

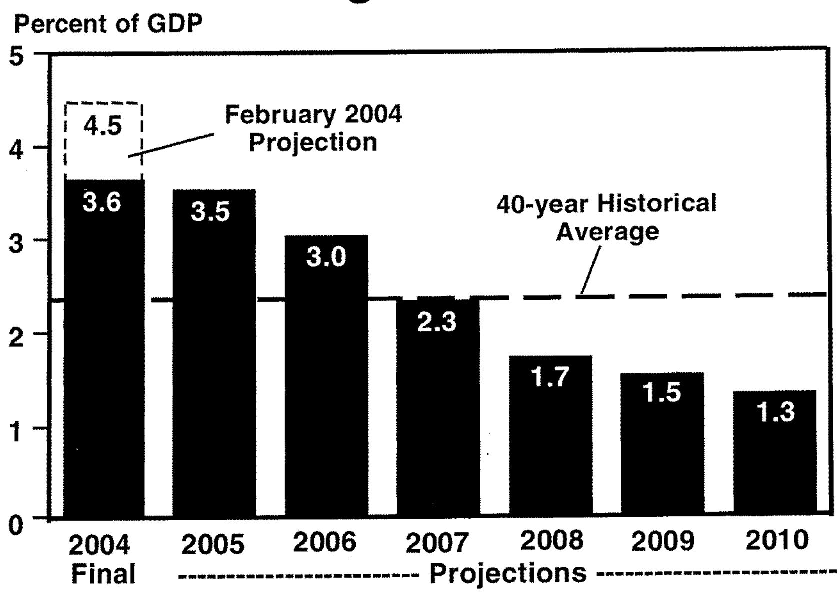
Just to go back to the Medicare estimates. Mr. Foster, who was Medicare's chief actuary for nearly a decade, said that administration officials threatened to fire him if he disclosed his belief in 2003 that the drug package would cost $500 to $600 billion.

That is why there is a credibility problem here. We were told as we were dealing with the legislation that the cost would be $400 billion. Then after it was passed, they let it be known that, oops, that was wrong, the real cost is over $530 billion. And now we are talking about a 10-year cost of $724 billion, accepting your offsets, which I do accept, $724 billion.

Now, this is the pattern as I see it. In 2001, the President told us we can proceed with tax relief without fear of budget deficits. That was clearly wrong. Then he told us in 2002, our budget will run a deficit that will be small and short-term. Obviously that was wrong because these are record deficits and they are for as far as the eye can see. In 2003, he told us that the current deficit is not large by historical standards and is manageable. I would submit to you that, correctly considered, these deficits are not small by historical standards either. The way he gets there is he just leaves out things.

In fact, I would like you to put up that chart, if you would again, showing the deficit reduction as a percentage of GDP, because I have to tell you, I think this hurts your credibility again because I think it misrepresents the true state of our fiscal condition.

## Cutting the Deficit



That is the that I want. Let me just say this to you: First of all, that chart leaves our war costs past September 30th of this year. That is No. 1.

Senator SARBANES. Is that correct?

Mr. BOLTEN. That is correct, and I would——

Senator SARBANES. Leaves out war costs after September 30th?

Mr. BOLTEN. It leaves out any supplemental spending after September 30th, and I think I was clear about that in my testimony, and it is clear in the budget documents as well.

Senator CONRAD. No. 2, what that chart leaves out most significantly is the money that you are taking from Social Security to pay for other things.

If you go back, because you are making a comparison back to the 1980's, back in the 1980's there was virtually no Social Security surplus. So if you look at this on an operating basis, you get quite a different picture. If you look at this on an operating basis, you know, no private sector company could take the retirement funds of its employees and use those to pay operating expenses. That is a violation of Federal law.

But in your budget, in the President's budget, he takes $2.6 trillion of Social Security money over the next 10 years to pay other operating costs. That is nowhere in these figures.

By the way, you do not have alternative minimum tax in there. Last year, at least you had it in for 1 year. This year you do not have it in at all. It costs over $700 billion to fix. It is not there.

So this is not a budget. This is a political document. It is a talking point. It fundamentally misleads people as to our fiscal condition. Even more serious is if you just go beyond the 5-year window, many of the costs of the President's policies explode, for example, the cost of making the tax cuts permanent. You only have the first 5 years there. You know and I know what happens after the first 5 years. The costs of those tax cuts in lost revenue to the Treasury absolutely explode.

So you have a chart here that does not reflect reality. It is not what is going to happen, and it is part of a pattern.

You know, I do not even know what to say to you in terms of how seriously I believe this misleads the American people. We are not on a course to substantially reduce deficits. We are on a course to a train wreck. We had the Comptroller General of the United States here yesterday. Boy, what a difference his testimony was from the testimony we are hearing today. He talked about $43 trillion of unfunded liabilities, $28 trillion of it in Medicare alone, and there is nothing in this plan that deals with that.

My time has expired, but I would just say that you have a presentation here that I do not think reflects reality.

Chairman GREGG. Thank you. That was a good question.

Senator Alexander.

Senator ALEXANDER. Thank you, Mr. Chairman.

I have some questions about Medicaid and then an observation about higher education. You said that you would reduce the growth in Medicaid spending from 7.4 to 7.2 percent. Do you know about what the rate of growth annually for Medicaid spending has been in the Federal Government and the State governments over the last 4 or 5 years?

Mr. BOLTEN. We will give that to you for the record, but I think it has been at about that level.

**Answer:** Average, annual Federal Medicaid growth was 9.8 percent from FY 2001 through FY 2005.

Senator ALEXANDER. State spending might have been higher.

Mr. BOLTEN. States, in fact, probably are experiencing a slightly higher rate of growth in their costs than even the Federal Government's 7-percent rate.

Senator ALEXANDER. What I would like to drive at here is a question really of federalism. You have a predecessor of yours who is now Governor of a State. You have a former Governor, Chairman of the Governors, who is the head of Health and Human Services. And if I am putting myself back into—if I were the Governor of Tennessee today, I would be looking at a State budget that might have, for example, approximately $10 billion of Federal funds that I manage and about $10 billion of State-collected tax dollars. And of the $10 billion of State-collected tax dollars, that would be most of the funding for kindergarten through the 12th grade, for colleges and universities, for parks and police, when you add in the local spending—in other words, many of the things that people really rely on for Government and that have to do with our future. To keep our competitiveness in the world marketplace, we need brain power, and that comes from improving our early education, our schools, and our universities. A lot of that is State funding.

So what is happening in Tennessee, as an example, is when I left the Governor's office 15 years ago, we were spending 51 cents of every dollar on education; today it is 40 cents. The reason is because 15 years ago it was 16 cents on Medicaid and today it is 26 cents, going up.

So if we are to continue to have quality universities and schools funded by State and local governments, we have to make sure that whatever we do here does not have the unintended consequence of tying the hands of Governors and Mayors who are trying to allocate funds so they all do not get eaten up by health care.

So what I want to urge you to do is to—and you said you would, but I just want to urge you to listen to the Governors as you restrain Medicaid spending. Because if I am sitting down there with $10 billion and that situation of health spending going up, there are two people who get in my way: one is the Federal Government, and one is the Federal courts. Because you say here is a cap, and then other agencies of the Federal Government say, "But you have to spend money on this person instead of third grade or this person instead of the community college." And then the Federal courts come in.

So that is just a general comment. I am working on some legislation that will make it easier for State and local governments to amend and adjust Federal consent decrees, which might help with that. But what is your attitude toward giving maximum flexibility to Governors and legislators as you seek to restrain the growth of Medicaid spending?

Mr. BOLTEN. Senator, that is precisely the direction we are trying to take the system because the restrictions that Governors face in the rules often make it very difficult for them to provide the care that is needed to the people who need it most and is eating an ever

larger portion of State budgets. So we are headed toward proposals of exactly the kind of flexibility you are talking about. Governor Leavitt understands that, I think, as you do because he is a former Governor. He made an excellent speech last week, which I commend to you—and we will gladly provide you a copy of it—outlining the principles that we are going to be pursuing in Medicaid reform, and I think you will find them entirely consistent with what you have just said.

United States Department of
Health & Human Services

REMARKS BY: Mike Leavitt, Secretary of Health and Human Services
PLACE: Marriott Wardman Park Hotel, Washington
DATE: Tuesday, February 1, 3:00 pm

## "Medicaid: A Time to Act"

Thank you, Dan. Good afternoon.

There is a time in the life of every problem when it is big enough to see but small enough to solve. For Medicaid, that window of opportunity is upon us. The time to act is now.

Medicaid is the spirit of American compassion in action. Through Medicaid, Americans help 46 million of our fellow citizens. This includes people with disabilities, the neediest of our elderly, and low-income families.

Until just over a year ago, I was this nation's longest-serving Governor. I was responsible for making Medicaid work in my state. And I know from experience that Medicaid is not meeting its potential. It is rigidly inflexible and inefficient. And, worst of all, it is not financially sustainable.

Over the past ten years, Medicaid spending doubled. And this year, for the first time ever, states spent more on Medicaid than they spent on education.

To illustrate this point, this morning I did a web search on the word Medicaid. Let me tell you what I found.

In Tennessee, budget pressures are displacing thousands of people from Tennessee's health program for the poor, Tenncare.

The deputy director of Ohio's Medicaid program summarized the situation by asking: "What's a word bigger than catastrophe?"

An Alabama paper discussed the legislative session that opens Tuesday by noting that one problem "looms over all the others: the funding crisis facing the state's Medicaid program."

In Ohio, a state legislator observed: "The question is going to end up being where do you cut and who is it going to hurt the most."

These state officials are worried. Low-income families are worried. And advocates are worried. They all want to solve this problem. But rigid rules are holding them back.

We need to have a serious discussion on Medicaid. And I want to open this discussion today by defining what success would look like and offering a general strategy to achieve that success.

Success to me has three components. First, keep faith with the commitment this nation has made to provide access to acute and long-term care services to people with low incomes, disabilities, the elderly, and children.

Second, create enough flexibility in Medicaid that states are able to continue serving optional groups and expand the number of people they serve.

Third, assure the financial sustainability of Medicaid by returning integrity to the funding partnership.

Today I want to offer thoughts in three areas: three myths, three changes, and three opportunities.

First, the three myths:

Myth one: Some have predicted that reform would break our commitment to our neediest and most vulnerable citizens: our mandatory populations, such as people with disabilities and children in low-income families or foster care. This is not true. These mandatory populations must continue to receive the comprehensive coverage that they receive now-including Early Periodic Screening Diagnosis and Treatment.

Myth two: Some are concerned that we will propose a block grant system, like the one that was discussed in 1995. NOT so. There will be no block grant system for Medicaid.

Myth three: Some expect that there will be a cut in available resources. NO again. While we must never stop looking for ways to make Medicaid efficient and to slow its growth, Medicaid will continue to be one of the fastest

growing items in the Federal budget, growing at an average rate that exceeds 7% per year. Over the next ten years, American taxpayers will spend nearly $5 trillion on Medicaid.

Those are the three myths. Now, I would like to suggest three changes to Medicaid. We've got to remove the vulnerabilities that threaten Medicaid's viability.

Change one: We must find every inefficiency, because waste means covering fewer people. We must stop overpaying for prescription drugs. Pharmacies and Medicare buy drugs wholesale for a low price. But under Medicaid, state governments usually pay a much higher price. We must change the law so that states pay the same low rate. This will save the federal government $15 billion over the next ten years. It will save state governments $11 billion.

Change two: Medicaid must not become an inheritance protection plan. Right now, many older Americans take advantage of Medicaid loopholes to become eligible for Medicaid by giving away assets to their children. There is a whole industry that actually helps people shift costs to the taxpayer. There are ways families can preserve assets without shifting the costs of long-term care to Medicaid. We must close these loopholes and focus Medicaid's resources on helping those who really need it. Doing so will save $4.5 billion during the next decade.

And finally, Change three: We must have an uncomfortable, but necessary, conversation with our funding partners, the states.

As a former Governor, I understand the pressure state budgets face, particularly given the lack of flexibility in the current Medicaid law. However, state officials have resorted to a variety of loopholes and accounting gimmicks that shift the costs they claim to pay to the taxpayers of other states. If we don't close these loopholes, we project that over the next ten years they will shift $40 billion through various means.

Let me illustrate with an analogy. I live on a cul de sac that has three houses. There's the Federal house, the States house, and the Jones house.

The Jones daughter has a chronic disease, and needs $1000 worth of treatment every month. The Joneses have no health insurance but the little girl will die without treatment.

I go to my other neighbor, Mr. States, and propose that we get together to help the Joneses.

I tell Mr. States, "You know the Joneses best. Why don't you work things out with them? I'm willing to pick up two thirds of the cost, if you will pay one third and make arrangements with the Joneses.

This works well for a while. Mrs. Jones's doctor sends the invoice directly to Mr. States every month. Mr. States pays the invoice, and then walks over to my house to collect my payment of 2/3.

A few years pass and my friend, Mr. States, starts to run short of money. Things are tight for all of us.

But Mr. States is really feeling the pinch. He goes to Mrs. Jones' doctor and says, "Listen, I'm having some trouble coming up with my share of the money. Here's an idea that's good for both of us."

Mr. States then talks to the doctor and suggests that he raise his price to $1500, but offer a "special Mr. States discount coupon" of $300.

When Mr. States drops by my house to get my money, he says, "Mr. Federal, I have some bad news; the doctor has raised his prices and the Jones's health care has now gone up from $1,000 to $1,500. I'm here to collect your share...let's see, 67% of $1500 is...yes, $1000.

I take his word for it and give him $1000.

Now, let's think about this. At the beginning, Mr. States was paying $333 for his one third. I assume with the price increase he's paying $500.

But I haven't accounted for the "special Mr. States discount coupon." Mr. States is now paying $200 instead of $333. I'm paying $1000 instead of $667. And together, we're paying $1200 instead of $1000.

Eventually, I discover what Mr. States has done. Now, I really like Mr. States. I really want to help the Jones daughter. But I don't feel particularly good about this arrangement. It's time for me to have an awkward conversation with Mr. States. I want to restore a straightforward, transparent, and effective system.

This analogy tells one general story of an accounting gimmick. But the Medicaid reality tells at least seven variations on this theme. A majority of states have employed one or more of these practices to maximize their reimbursement. With apologies to my friend Stephen Covey, I call them the Seven Harmful Habits of Highly Desperate States.

Let me give you some examples of these Harmful Habits.

One harmful habit is double dipping, just like the story I told. States overpay providers, get the overpayment returned to them, and spend the same dollars a second time. It's a shell game that makes no one healthier. We need to ensure that states meet commitments with real dollars.

Another harmful habit is inflated overhead. States are shifting costs to the federal treasury for "administration." This accounting gimmick encourages wasteful spending and bloated bureaucracy.

I won't list all seven, but you get the idea.

I want to stress that I sympathize with the state officials who face these pressures. I know why they act this way. I've been a governor, and I've struggled to make Utah's Medicaid system balance its budget and meet its commitments. This isn't about blame; it's a simple statement that it has to stop.

We must stop harmful habits that are needlessly driving up costs. We must stop overpaying for drugs. We must stop rewarding higher spending and start rewarding better performance. And we must start ensuring that Medicaid is saved for those truly in need. If we make these changes, we can make Medicaid an economically sustainable program that will provide essential health coverage for more Americans and better long-term care choices for seniors and the disabled.

Those are the three changes. Now let's talk about opportunities. We are looking at many ideas to improve Medicaid coverage. Let me talk about three of them.

First, we can ensure that seniors and people with disabilities get long-term care where they want it. The President's New Freedom Initiative points us in the right direction. Home care and community care can allow many Americans with disabilities to continue to live at home, where they can enjoy family, neighbors, and the comfort of familiar surroundings. Medicaid should not force these people to live in institutions. Just as importantly, we can serve more people.

Look at Vermont and New Hampshire. Vermont has a highly developed home and community based health care system. New Hampshire continues to rely on institutional care. In Vermont, 85% of Medicaid population over 65 still live at home. In New Hampshire, only half can live at home. And Vermont spends less than half as much per elderly person on Medicaid as New

Hampshire, freeing up money that can serve more people.

Let me repeat that. Providing the care that lets people live at home if they want is less expensive than providing nursing home care. It frees up resources that can help other people. And obviously, many people are happier living at home.

Second, we can expand access to more children. We will discuss this further in the next few weeks. But the principles will be the same. We can provide access to more needy people by providing common sense flexibility.

Third, improving coverage of optional populations. Whether it's a lady in a nursing home or a boy in a wheelchair, we have a very special obligation to our neighbors who are elderly, low-income, or have disabilities. We meet that obligation by providing a comprehensive package of benefits and services. Mandatory populations need the help. They must receive the help.

The optional populations, on the other hand, may not need such a comprehensive solution. Most of them are healthy people who just need help paying for health insurance.

We've already proven a way to provide that help. The State Children's Health Insurance Program, S-CHIP has allowed 5.8 million children in low-income families who don't qualify for Medicaid to have health insurance.

One of the key reasons S-CHIP has been such a resounding success is that it allows states to ask the question, "What is quality basic health coverage?" And each state can choose from five answers: the health benefits state employees get, the benefits federal employees get, the best private health plan in their state, Medicaid, or some hybrid of private and government plans. Fewer than 20 states and territories chose the straight Medicaid option. A majority chose some other combination. It costs states less, on average, to provide health insurance than to provide comprehensive care.

Wouldn't it be better to provide health insurance to more people, rather than comprehensive care to a smaller group? Wouldn't it be better to give Chevies to everyone rather than Cadillacs to a few?

I am already working with governors and other state officials to strengthen and modernize Medicaid. And I look forward to working with them, with members of Congress, and with all of you in the health care community to ensure that every family in America has the power to make wise, well-informed decisions to sustain and improve their health.

We can be a nation of healthier Americans. A nation where health insurance is within the reach of every American. A nation where seniors and people with disabilities get long term care where they want it.

We can transform our health care system so informed consumers own their own health records, own their health savings, and own their own health insurance. Ownership engages consumers, and engaged consumers get better results.

We can be a nation where families embrace the power of prevention and wellness-where fewer people get sick because they take action to stay healthy.

We can be a nation where American workers have a comparative advantage in the global economy because they are healthy and productive and because, through the power of technology, our health care system produces fewer mistakes, lower costs, and better health.

We can do all of this in a way that makes our economy and our health care sustainable, compassionate, and competitive. Let's get to work.

Thank you.

Last revised: February 1, 2005

Senator ALEXANDER. I have one observation I would like to make, and if there is time for you to comment, fine. When I left the former President Bush's Cabinet as Education Secretary in 1993, when the voters ushered us out of office, there was one regret I had and it was that I had not volunteered to be the point person for higher education, because as I have looked through all of Government, it was all over the place. It was in the Defense Department. it was in NSF. It was in the National Institutes of Health. It was in Pell grants. It was in a variety of places. And about half our economic growth since World War II has come as a result of our investments in science and technologies, the national laboratories, the research that we do.

I think administrations need a point person on all that we spend and all that we do in science and technology and higher education, especially now that competitiveness is such a major issue and other countries are keeping their better students home, building up their universities, trying to compete with our national laboratories. And I just offer that to you since management is another part of your responsibility, and it is something that I would like to suggest that the administration consider.

Mr. BOLTEN. Thank you, Senator.

Chairman GREGG. Senator Murray.

Senator MURRAY. Thank you very much, Mr. Chairman.

Mr. Director, appreciate your being here today. I listened to the President's State of the Union Address last week, and he told us he was going to send the budget and would focus on essential priorities, so I was looking forward to seeing it. I guess I was really disappointed to find out what was not essential priorities, things like veterans and students and securing our ports and borders and affordable health care and nuclear waste cleanup, and I think that sends a very bad message to our country right now. I do not know how we can maintain a strong defense if we are going to cut veterans' access to health care or how we can make sure we have strong homeland security if we are eliminating funding for our port security grants, and I do not believe we can strengthen our economy if we are going to reduce our investments in education and job training and infrastructure at a time when everyone is asking how can we be secure. I think this budget really undermines that security, and I echo the comments of Senator Conrad on what this budget really is, how real it is and masking it.

But let me for this time, since my time is short, focus on a very parochial issue. Actually, it is not real parochial. It is the Pacific Northwest which you should know is up in arms over your proposal to force our power marketing administration to charge market-based rates for electricity. I think there are eight Senators on this committee alone who are going to be affected by that, and I want you to know that our region does not want to see this budget balanced on the back of our rate payers.

But that is not the only legislative proposal in your budget that is going to undercut Bonneville Power Administration. You also propose to hold certain financial transactions, such as third-party financing, against BPA's borrowing authority. I have to tell you that is really rich with irony because for 2 years OMB opposed our efforts to raise BPA's borrowing authority in order to make nec-

essary investments in transmission and other capital projects that were needed. And in 2003 OMB finally supported half of BPA's needed borrowing authority but said that they should use other financing means like third party financing to meet the remainder of its investment needs. So here we are a couple of years later, and you are proposing to undercut the ability of BPA to use third party financing by holding these and other types of transactions against their borrowing authority limit. These kinds of proposals are going to cripple BPA's ability to meet their investment needs.

Mr. Bolten, President Bush came out to my home State, Washington State, in July 1999, and he came out again in 2003, and stood at Ice Harbor Dam, and he promised to save the dams. I cannot believe that this budget is making two different proposals that is going to severely undermine the value of those very dams that he promised he was going to save.

My question to you this morning is, is it the intention of President Bush to privatize BPA and other PMAs?

Mr. BOLTEN. No, that is not reflected in these proposals, and I do not think these proposals in any respect undermine the value of the dams out there. All that we are asking in these proposals is that the power marketing authorities charge their customers a reasonable market rate, not a subsidized rate for which the rest of the taxpayers in this country are paying, but a——

Senator MURRAY. The rest of the taxpayers are not subsidizing Bonneville. We pay the rates.

Mr. BOLTEN. I think we have a disagreement on facts on that, and CBO has found that most of the PMAs in fact do receive a subsidy from the Federal Government. But even beyond that, when the Government is engaged in a commercial venture, I think using assets created with Federal taxpayers' dollars, especially in these times of deficit, it is reasonable to expect that those commercial ventures charge their customers a reasonable market rate. That is all we are asking, and I think particularly the customers of BPA will find that we are talking about a very modest increase in the subsidized rates that they now——

Senator MURRAY. 20 percent increase in our cost of heating our homes, providing electricity to many businesses who rely on it is going to cripple the economy in the Pacific Northwest. We are just beginning to drag out of the economic damages from the last 4 years which started with an electricity crisis which I will not go into, that had to do with Enron. I believe there are a number of other members on this committee who share that viewpoint with me, but we cannot cripple the Pacific Northwest. These are not subsidized rates. We pay the rates for our electricity out there. I will tell you what, the Northwest is not going to stand there and take this, we are going to fight back.

Mr. Chairman, I know I am out of time. I have a number of other questions for you including the proposed cuts to Hanford Nuclear Reservation Cleanup, and you will be hearing more from me on that on the next round.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

I just want to understand what has happened in Social Security since its very inception. It seems that every President has used the surplus coming in from the Social Security money, the FICA tax, and spent it because we have bought bonds, put the bonds in the trust fund, and spent the money that we got from those bonds for other government functions. Is that a fact?

Mr. BOLTEN. That is true.

Senator BUNNING. Since the inception of Social Security?

Mr. BOLTEN. I believe that is true, yes.

Senator BUNNING. It is true. In 13 years, 2018, is it also true that Social Security will then be paying out in actual dollars more than they take in in actual dollars?

Mr. BOLTEN. That is the currently projected date that Social Security will go into cash deficit.

Senator BUNNING. If we do nothing, if we do nothing in that respect, then eventually if we deem every bond that is in the trust fund, and we pay all the interest due on that bond, there is a difference of opinion between CBO and the trustees when eventually we run out of money, and if we do not change the current law which says you cannot pay out more than you take in, somewhere around 2042, between 2042, 2052, there will be a reduction of about 25 percent in benefits if we do not change the law. Is that correct?

Mr. BOLTEN. That is correct, Senator. That is the Social Security actuaries estimate is 2042, and I believe they expect——

Senator BUNNING. CBO's was 2052.

Mr. BOLTEN. On some different assumptions.

Senator BUNNING. We will give them a 10-year leeway, and maybe in the middle.

Mr. BOLTEN. Yes. And I think their estimate was that thereafter the system would be able to pay only slightly more than 70 percent of the promised benefits.

Senator BUNNING. There is a difference of opinion there too, from 72 to 78 percent, but somewhere under 80 percent. That is the law as it is now written.

Mr. BOLTEN. Correct.

Senator BUNNING. So if we do not change the law, the Social Security law, we are not going to be able to pay my grandkids their benefits, the ones that would retire after 2042 or 2052?

Mr. BOLTEN. Correct.

Senator BUNNING. So it is not unusual to use that money, but perfectly normal?

Mr. BOLTEN. Well, that has been the practice in Government. And the way we have accounted for it has been the consistent practice.

Senator BUNNING. In the Department of Energy's budget the administration has proposed to cancel funding for the Clean Coal Technology Program, which researches advanced clean coal based technologies, and instead redirect the funds to FutureGen, which researches creating hydrogen power from coal. Why is the administration focusing more on the FutureGen than on other types of technologies to burn coal cleaner to produce electricity?

Mr. BOLTEN. Senator, I will ask to come back to you on the record for that. But my understanding is that we are continuing to

fund a variety of clean coal technologies, that FutureGen holds a lot or promise and——

**Question: Why is the Administration focusing more on FutureGen than on other types of technologies to burn coal cleaner to produce electricity?**

Answer: The Administration has a diverse portfolio of research, development, and demonstration projects and is advancing many different types of technology to make coal-fired power plants cleaner and more efficient, including both gasification and combustion-based approaches. The decision to use integrated gasification combined cycle technology in FutureGen reflects the level of maturity for testing IGCC in an integrated mode with carbon sequestration. The IGCC concept for FutureGen was vetted in the Department's Request for Information in FY 2003, and the feedback received had no indication of objections to, but rather support for, an IGCC based FutureGen concept.

The Clean Coal Power Initiative (CCPI) can, and has, provided funding for combustion and other power systems that can meet the performance criteria for a given competitive solicitation. The Budget ensures that unexpended funds available from the Clean Coal Technology Program (CCTP) are available to fund future clean coal activities, including CCPI, which is CCTP's successor program. The 2006 Budget includes $68 million for CCPI, matching the 2005 enacted level, of which $18 million is allocated to continue development of FutureGen, the multi-year, coal-fueled, near-zero-emissions electricity and hydrogen generation project announced by the President in February 2003.

For existing combustion power plants, the key to their continuing operations is their ability to meet ever tighter emission regulations, including the control of new regulated pollutants, such as mercury. The entire "Innovations for Existing Plants" Program is focused on developing new low-cost emission control technologies for existing combustion plants. The FY06 budget request for this program is $23.9 million—an increase of 25% over the currently enacted level. To maximize the efficiency of new combustion power plants, the FY 2006 budget request continues funding (under Advanced Research/Materials) with the Energy Industries of Ohio and national labs to develop materials for ultra-supercritical combustion power plants. Funding is also requested for the development of high temperature corrosion resistant materials in general. Development is also continued for steam turbine materials capable of operating under ultra-supercritical conditions. The sequestration program is also investigating $CO_2$ capture technologies for both combustion and gasification systems.

Senator BUNNING. Yes, but that is not a huge expenditure, but it is transferring out of what we had proposed in the last bill, energy bill that did not quite get through. But the fact is we need to develop every technology possible so that when we are producing 52 percent of our electricity from coal generation, we ought to at least try to do the best job we can in America, in the United States at least to clean up. I know if we do nothing China will suffocate us all with the amount of coal-based non-clean technology that they are burning and producing power from, but I think it is very important that we develop all the clean coal technologies that we can, and I will work hard to alter some of the things that have been put in this budget.

Thank you.

Chairman GREGG. Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Welcome, Mr. Bolten. I want to ask a question. I read something in the Post that said that you acknowledged yesterday in a House committee that private accounts and personal accounts do not in themselves solve the full Social Security problem. Is that correct?

Mr. BOLTEN. The personal accounts that the President is proposing——

Senator CORZINE. Do not deal with the problem of solvency from 2042 or 2052?

Mr. BOLTEN. They do not in and of themselves solve that problem, but I believe they are an integral part of any reform program that does solve the permanent problem.

Senator CORZINE. But it is really addressing an issue other than the solvency, part of promoting savings or some other objective other than dealing with the solvency?

Mr. BOLTEN. The view I take is that the personal accounts are an integral part of a plan that fully addresses the permanent solvency of Social Security.

Senator CORZINE. Could you explain to me how that is going to improve the solvency of the Social Security accounts?

Mr. BOLTEN. The creation of personal accounts?

Senator CORZINE. Yes. I mean it may be an integral part of something, but how is it dealing with the solvency question?

Mr. BOLTEN. In and of themselves they do not address the solvency question, but they do provide the recipients of the personal accounts an opportunity to get a better return than they otherwise would——

Senator CORZINE. Given whatever the sort of efficient market would allow people to be able to do. I just wanted to make sure that I had read that there is a difference between how they impact in dealing with the issue of solvency in 2042, 2052.

Let me a second—and I will not go through this issue of credibility with regard to what I would call two sets of books if I were seeing budgets like this back in the world that I used to live in, and you left out revenue flows or expenses that were broad and deep into what people would want to see on getting to a bottom line, whether it is this Medicare issue, Social Security transition, AMT full implementation, war costs. I think it is very troubling because I do not know how any of us can go sit with our constituents and tell them that we have a budget, when we know that is not

reflective of the challenges we have to take on. So I certainly identify with the articulate analysis that Senator Conrad brought forward, and I think it hurts our ability to deal with some of the other tough issues because we do have entitlement problems in this country. But if we are not fair and square about what it is that the costs are of both sides of the ledger, whether it is revenue raising from taxes or how we are going to spend money, I do not know how we can sit down and ask the American people to make clear choices. We are leaving out so much here, that I think we leave that in a very failed position.

I also want to take a follow-on to what Senator Alexander said or talked about. If State Homeland Security grants are cut 30 percent, if my favorite railroad, Amtrak, was cut from $1.2 billion to $360 million for operating basis, if Medicaid at $100 million was cut to States, COPS programs, Fire Acts, Perkins Vocational Technical Education grants, what do we think would be the result to State budgets, and after school and day care, community development block grants, what is the end result when we push this off the budget? Are we going to say that our poverty levels are going to go down, that health care coverage is going to go up in the country? Is that the conclusion that these kinds of cuts, that educational levels are going to improve? What are our State and local governments going to do when they have mandates and the Federal portion of support does not happen?

What is the expectation on the end results with regard to people's lives, with regard to poverty, with regard to health care, with regard to quality education if the money does not flow and shared by the Federal Government?

Mr. BOLTEN. Senator, let me come back first to your concerns about what is not reflected in the budget. I believe that the presentation I have made, the charts that I have put up here are an accurate reflection of what our budget picture looks like. I have said explicitly in my testimony, and it is explicit in this budget, that war costs beyond those that are contained in the 2005 supplemental are not included. So we do have to expect that there will be an addition there.

Senator CORZINE. Respectfully, do you—and I mean that in all sincerity—respectfully, aren't we going to deal with AMT in this country sometime in the next, one, two, three, 4 years?

Mr. BOLTEN. I hope we will deal with AMT, but the President has asked the Secretary of Treasury to deal with that in the context of revenue neutral, overall fundamental tax reform. So we have not carried a patch, and it seems to me it is inappropriate to carry a patch year after year for a system that is as broken and complex and unfair as the AMT is. It seems to me that AMT is a proper subject to be considered in fundamental tax reform that the President has also called for.

Chairman GREGG. Senator, we are going to have to move on, unfortunately.

Senator CRAPO.

Senator CRAPO. Thank you very much, Mr. Chairman.

Director Bolten, I am going to make a couple of statements first just to commend you on some things and raise a concern on a cou-

ple of things, and then talk to you about some questions I would like you to answer.

The first thing I would like to commend you on in the budget, is the Administration's commitment to nuclear power. You and I have had several meetings on this issue and I appreciate the fact that you heard and responded well to the concerns that we have raised about the importance of making sure that this budget supports our movement in our energy policy in this country toward a strong nuclear power program. I just wanted to, first of all, commend you and thank you on that.

On the other side of the ledger, I have to say that I agree with those who say you have it wrong on the Bonneville Power Administration. There is no subsidy there and I believe that when we get into the details of that you will see the distinction that we are making.

I want to, in my questions, I wanted to go back to the question that you answered from Senator Corzine about the solvency issue with regard to Social Security, because, frankly, I understand it a little different and I want to get this straight. I clearly understand that initiating a system of personal accounts will not impact the short term solvency issues because, frankly, it takes a number of years for investment in accounts and for the buildup in those accounts to take place before you can start having the growth that we want to see develop.

However, in terms of the outyears of Social Security where we are seeing the big problems, it is my understanding that all these transition costs that we are talking about are, in reality, the costs that we are going to try to incur up front now for debt obligations of the Social Security system that will be present in the outyears. Is that not correct?

Mr. BOLTEN. That's correct.

Senator CRAPO. If we are utilizing a personal account system to create a better investment opportunity with a greater return to handle outyear debt, how can that not have an impact on the ultimate solvency of Social Security in the outyears as we have a much stronger fiscal position in those years as the obligations of the system then come due?

Mr. BOLTEN. I think you have given a clearer explanation than I was able to give earlier, and you are absolutely right. As we create personal accounts, all we are doing is taking an obligation that the Government will owe in the form of future benefits to a beneficiary and letting them keep that money earlier on and earn a higher return on it than the Social Security system can possibly promise to pay. So in that respect, it is largely neutral to the Government. It is a cost that we are just moving forward.

In the context of an overall, comprehensive reform plan that allows people to keep more of their money earlier on and increase the amount of benefit they can get from that, that is part of the whole plan of bringing the whole social security system into solvency.

Senator CRAPO. Thank you. In the time that I have left I want to shift gears yet once again. That is, it is my understanding that you have introduced a proposal in this budget that I guess we could basically call it administrative PAYGO, in terms of a proposal to have the administrative actions that any agency may take which

could increase the cost of an entitlement program, to be subject to a PAYGO principle or equal reductions would have to be kept in place so that the net cost would not be driven up in entitlement programs by agency actions.

Could you explain that a little better? I think it is a tremendous idea but I would like to know exactly how that works.

Mr. BOLTEN. You described it accurately. It is still in gestation. It is a new idea for us, but we have found that a lot of the growth in costs in our entitlement programs is not just the result of the automatic pilot feature of legislation. It is administrative decisions made by individual agencies. As a way of helping us at OMB and elsewhere in the Government get control of costs that might just be growing without any particular action having been taken, we are going to be asking agencies, as they make proposals for administrative changes for changes in regulations, when we assess that those proposals are going to result in an increase in the cost of those programs, we are going to ask the agencies to come forward at the same time with an offsetting decrease in cost. So we are going to ask them to do the same kind of PAYGO exercise that we are asking you to go through as you consider mandatory legislation.

Senator CRAPO. Are you going to do that through some type of executive order, or would this be something better done by legislative action?

Mr. BOLTEN. We were planning to do it through administrative action internal in the Administration, but we would be happy to work with you on appropriate legislation if that is of interest to you.

Senator CRAPO. Thank you very much.

Chairman GREGG. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman.

Good morning. Thank you for being here. It is hard to know where to begin there are so many questions that I would like to ask. I am drawn to your opening statement when you indicated that you presented a budget on behalf of the President that meets the priorities of the Nation. I think it is important to look at what those priorities are and then I want to ask a question about Social Security.

Some veterans under your budget will be greeted with a new $250 prescription drug coverage enrollment fee and a doubling of their copayments. Are you suggesting that meets the priorities of the Nation?

Mr. BOLTEN. Senator, we have proposed these additional fees in the past. They are for category seven and eight veterans. What we are asking those veterans to do is pay an enrollment fee of $250 to be part of the VA medical care system, and to pay a copay on their drugs that would rise from $7 to $15. I think most people who are operating under good health plans would not consider a $15 copay to be something out of range.

But here is the reason we are doing it. While we are expanding the expenditure on veterans health care, which by the way has grown by almost 50 percent over the course of this Administration, while we are expanding what we are spending on veterans health care, we are trying to focus on the core mission of the Veterans Ad-

ministration, which is to take care especially of those who have service-related disabilities and similar categories, the higher up categories. When we ask those in the lower down categories to pay some higher fees, the purpose of that is to capture some extra revenue to be spending it on those higher priorities, which we are doing.

Senator STABENOW. I understand that. So some veterans are going to be greeted with a new $250 prescription drug coverage enrollment fee and a doubling of their copays. I would just remind you that we have certainly been spending more on veterans health care but still have long lines of folks waiting to see doctors. We are creating more veterans also every day because of our brave men and women. I had an opportunity to spend time with some in the Upper Peninsula of Michigan on Sunday to thank them for their service. They expect to come home to a fully funded veterans health care system that does not continue to fund the system by asking additional dollars from them.

But another question, on first responders. Very important to us certainly in Michigan and around the country. The budget cuts overall first responder funding by 38 percent, the formula funding by 26 percent below current levels. Firefighter grants, which have been critical to us in Michigan are being cut 30 percent below last year's levels and below homeland security levels. A 96 percent cut in the COPS program, which has put over 3,500 new officers on the streets in Michigan. I could go on.

I would just suggest to you, that does not meet the priorities of the Nation.

The final thing I would say is that we look at a number of areas of research and development, the manufacturing extension partnership for small and medium-sized manufacturers which gives them the technology and the support to be able to compete in the global economy; dramatically cutting that back. It is about jobs. It is about loss of profit. It is about inability to compete. It is penny-wise and pound-foolish, and I would suggest does not meet the priorities of the Nation.

One question though on Social Security. There is a lot of confusion about what has been called the clawback provision; a very lovely title. The clawback provision basically really goes to the question of what happens when people put money into the privatized accounts. We frequently hear about, it is your money and it is your money whether it is payment into an insurance system in Social Security, 100 percent funded by all of us working, or whether it is the privatized accounts.

But is it not true that at this point from what we are hearing from briefings, from reports and so on, that workers who choose privatized accounts would have to pay a portion of those accounts back in terms of their retirement? In other words, get less in traditional benefits. Some estimate that this provision, which is also being called a retirement tax, could be between 70 and 100 percent of the value of the person's privatized account.

For example, if someone set up a private account and it grew only 3 percent above inflation, the net effect would be that all of his or her privatized account earnings would be taken away in benefit cuts. Is that not correct?

Mr. BOLTEN. I do not believe so, Senator, but I think you have to look at whatever the Social Security plan is in its totality. What I do know about the personal accounts that the President has talked about is that his intention is that people be able to keep all of what they invest in those accounts and realize all of the returns which, over any historical measure, are likely to be far better than what they can get in the public sector.

But may I take a moment on your point on priorities? Because you listed a lot of programs, and you listed a lot of tough cuts. But that is what this budgeting is about. If we are going to get control of our spending situation, we do have to set some priorities and take down the numbers in a lot of programs that are very popular all over the country, and that includes some of the grants that you talked about. What we need to focus on is making sure that our grants go toward actually improving homeland security. It would be——

Senator STABENOW. Mr Bolten, since my time is up I am going to just ask—I apologize for cutting you off because I assume I am going to be cutoff here in a moment to move on to other colleagues. I want to talk to you more about what the reality of these privatized accounts is at some later point, but let me just suggest this.

We all know that we could eliminate the entire non-defense, non-homeland security, domestic budget and not solve this year's deficit. We are talking about focusing on small investments with huge impacts in terms of safety, and security, and education, and research, and supporting our veterans, and yet we have no discussion of the larger issues that have been raised by my colleagues in terms of the tax plan and where revenues go versus what we are asking of our veterans to pay for prescription drugs, or what we invest to keep people safe. I would just suggest that this does not reflect our priorities, nor does it reflect a true budget and I would hope that we could do better.

Thank you.

Chairman GREGG. Senator Sessions.

Senator SESSIONS. Thank you, Mr. Chairman.

I believe that first chart or two that you had there showed revenue coming into the Government. If you could find that and put that up, I would appreciate it. We have had an increase in revenue and one reason I believe, Mr. Bolten, is that we have created a tax system that really focuses on the affluent. The income tax is heavily skewed to the affluent, and it seems to me that it is a reality all of us need to consider that when the economy goes down and the affluent, who have been making high incomes and paying 35, 39 percent tax on that, do not pay it. If the stock market goes down and they sell stocks, they take losses instead of gains, and maybe their investments do not pan out as well and they just do not pay as much in taxes.

That shows to me a little bit of a confirmation of that thought I have had for some time. Are you concerned that that is a problem for us in the way we collect taxes in terms of our ability to predict each year what the revenue will be?

Mr. BOLTEN. I certainly agree with the description of the problem which is that we had surpluses, or we thought we had surpluses

at the end of the last decade because the Federal Government was receiving huge revenues in large part from a stock market bubble. When that bubble burst and wealthy people, instead of paying large capital gains, had capital losses, revenue dropped off a cliff for this Government. I think what you see reflected up here is that in the first 3 years of this Administration, as a result largely of that situation that the President encountered on entering office of a burst stock market bubble, a recession, then the 9/11 attacks, for the first time since the 1920's the Federal Government experienced actually declining revenues for three straight years in a row.

Now you and the President put in place some very effective tax cuts that helped restore economic growth——

Senator SESSIONS. Those tax cuts, according to conventional liberal wisdom would result in reduced revenue to the Government, would it not? We cut taxes. Why don't revenues go down?

Mr. BOLTEN. What this reflects is that revenues are coming back strongly. After this 3-year actual decline in revenues, we now have revenues coming back strongly, $100 billion last year; and we project more than that for this year. It is because we have a strongly growing economy. That is the most important fiscal tool we have. There is nothing else in the toolbox that comes close to a vigorously growing economy to determine whether we are in a good fiscal situation.

Senator SESSIONS. I do not mean to totally argue with my colleagues here, but I do think that growth in the economy has resulted in increased revenue even though we have a lower tax rate.

With regard to how we got into some of this and the spending that we incurred. I remember the last year of the Clinton Administration, the increase in appropriations that year was 15 percent. I do not know how that all happened, but it happened, and I think a lot of us regret that we participated in such a large growth rate. If we contain spending I think we have a way to work through this.

I am concerned, as several have expressed, the prescription drug bill. We went from zero on prescription drugs under Medicare basically to a very substantial commitment to increase that. We did not, I do not believe, any of us think that we were doing an open-ended program that would grow completely out of control. I think we may need legislation. I think we may need tough regulations from the Administration. But I believe there is a commitment here to contain Medicare prescription drug spending to the $400 billion over the first 10 years, as you noted. We all knew it was going to go up over years two through 12; it would be higher. But not that much higher.

So do we have any interest on the part of the Administration in trying to be faithful to the basic commitment that we had when we passed this bill to see that this prescription drug program not get out of control?

Mr. BOLTEN. Sure we do, Senator, and we would be glad to work with you on whatever cost control measures you are interested in pursuing.

Senator SESSION. I would just ask, Mr. Chairman, that I submit a written question about Medicaid and the impact on the States. I am very concerned about that.

Chairman GREGG. Thank you.

Senator SARBANES.

Senator SARBANES. Thank you very much, Mr. Chairman.

Senator DOMENICI. Senator Sarbanes, I wonder if you would yield for an observation.

Senator SARBANES. Not out of my time, but otherwise, yes.

Senator DOMENICI. I want to say, Mr. Chairman, as chairman of the Energy and Natural Resources Committee I have a markup of 10 or 15 bills for Senators that have to be voted out. It takes a very little bit of time, and I do want to come back, if I can. If you are finished, then you are finished. But could I just say, first I would compliment you——

Senator SARBANES. Mr. Chairman, I will yield my time to Senator Domenici. He can get his questioning in and then go to the markup and he will not have that problem.

Chairman GREGG. That is very generous of you, Senator Sarbanes. Then we will come back to you.

Senator DOMENICI. That is very good. Thank you, Senator.

Chairman GREGG. Very nice of you, Senator Sarbanes. Thank you.

Senator DOMENICI. First, let me say I congratulate you on your efforts. Considering the things that nobody wants to touch around here, which are entitlements, and in particular, health care, which sooner or later we are going to have to realize we cannot afford what we are trying to do in health care. I do not ask you to comment. I do not want you to commit to that terrible proposition. But it is obvious we cannot pay for the entitlements that we have over time if we want a growing economy and low inflation, which are the really cornerstones of America's prosperity. That is my absolute conviction. I do not think we have done much about that.

But for those who say we should, it is very interesting. You are trying to do something with Social Security. They suggest you should do Medicare. If you had tried Medicare they would all be saying, why don't you do Social Security? Or, we cannot cut Medicare. So at least you took one of them on and you are going try.

I have two observations for you and I really urge you to think about it and urge that you tell the President about it. You have some things in this budget that say we ought to make changes. We ought to get rid of some programs. There is no question, three-quarters of those programs that you want to cut are just not needed. They are duplicative. There are four or five of them doing the same thing. But you know what happens? We do not do them because we do not have an easy way. We cannot do them. There is no way to authorize their death, so it is all up to appropriators.

I submit that you have to do more to see, and force, and insist that Congress do what you have asked for. Now that is not easy. I never hear the Administration say, this appropriation bill did not cut the 10 programs that we asked for. Have you ever done that as a budget director? I do not think so. How are we going to get them? It is your program. So I urge that you do that.

My last one has to do with energy. I note the President's speech to the Detroit Growth Club, or whatever it is, on energy. I also want to tell you, again, that he got the greatest applause, according to the report, when he said we have to do something about nuclear

power. Thank you and thank him for proceeding with it. We are going to try. I hope you help us.

My last question is ANWR. Now there is some rumbling around that the Administration may not be for pushing ANWR to the maximum. It is in your budget by way of expected revenues, right?

Mr. BOLTEN. Yes, it is.

Senator DOMENICI. Now you intend for us to try to do that, do you not?

Mr. BOLTEN. Yes, we do, Senator.

Senator DOMENICI. So you support doing whatever we can do that is legitimate up here and consistent with our processes to get ANWR done, right?

Mr. BOLTEN. Only legitimate activity, yes, sir.

Senator DOMENICI. Of course. I do not mean illegitimate in that sense, but that are consistent with our rules.

Mr. BOLTEN. Yes, sir.

Senator DOMENICI. Whatever we can do you would ask us to do. You would have no objection if we put ANWR in our budget as an item that we should mandate, do you?

Mr. BOLTEN. I do not expect we would, Senator.

Senator DOMENICI. Now my last point is way, way out in left field. Would you support, as a reform measure, 2-year budgeting and 2-year appropriating? I look around here and I do not know how you can get your agenda down because we cannot get our work done. It seems to me we ought to try to do something different. What do you think about that?

Mr. BOLTEN. It is an interesting concept. The President actually talked about that in the 2000 campaign and we have carried it before in our budgets. It did not attract a lot of interest up here in the Congress, but I would be interested in opening the dialog on it because I think it would provide an opportunity for us to focus 1 year on the numbers and the appropriating and another year on the implementation.

Senator DOMENICI. Now my last issue has to do—I have been watching people who either do not like the President—it seems there is a large group of people that even though he has been elected seem to want to get on and express their extreme dislike for him, and when it gets to the budget they do that, and they really criticize you for not putting the 1-year appropriation supplemental for defense in this budget. Could you just tell us, since there are a few people watching, in very simple language, why shouldn't you put that in the budget in terms of this 5-year budget?

Mr. BOLTEN. As a budget director, it is very important to me that we not include one-time, extraordinary war costs in a budget because if you put it in the basic budget it ends up in the base and you never get rid of it. It just grows from there.

So we are restoring our underlying military strength through progressive increases in the base defense budget. But when we have an extraordinary episode, like a war, we need to fund that separately. We try to show those costs as transparently as we possibly can, including the supplemental request that you will be receiving shortly. But I think as a budgeting matter it is very important that we not let these things float into the base because then

I think we will have been fiscally irresponsible in not preventing those costs from being permanently in the defense base.

Senator DOMENICI. So a way of saying it is if you put these costs in the budget and they are supposed to be one time expenditures, Congress could in fact expect them to be in beyond that time and plan their spending, to include the spending as if it were in there permanently, so you keep it out.

Mr. BOLTEN. Senator, I fear that not just Congress but a lot of other people who are interested would assume that we would be doing that spending in perpetuity.

Senator DOMENICI. Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator Domenici. And thank you, Senator Sarbanes, for allowing Senator Domenici to go. Which means that after Senator Sarbanes, Senator Wyden would be next.

Senator SARBANES. Mr. Bolten, I have been listening to you with great interest this morning and I was really struck by the feeling that the qualities that are needed nowadays to be a good OMB director, at least as you all are doing the business, are those of a magician. I just want to put that out at the outset.

Now let me ask you a couple of questions. You said earlier, as I understood it, that it has always been the case that the Social Security surplus has been used to pay for other programs; is that correct?

Mr. BOLTEN. I believe it has, but there have been periods when the surplus has actually been paid down. So I think there was a brief period in the 1990's when the money went the other way, when the Government was actually in surplus.

Senator SARBANES. That was not your answer. That is an elaboration on your answer. That was not how I understood it at the time. You said it was always the case, and I would just refer you to your own budget document which shows that in both 1999 and 2000 we had an on-budget surplus.

Mr. BOLTEN. Correct.

Senator SARBANES. So we were not using the Social Security surplus to pay for other programs, correct?

Mr. BOLTEN. Yes, that is correct, in those years when the Government was running a surplus.

Senator SARBANES. I just want to get things clarified and I want to make sure we at least try to see if we cannot get some agreement on what the facts are.

Second, you just talked about a 2-year budget, but I understand that in the budget you have just submitted there is a major departure in that with respect to projections of discretionary domestic spending you provided only 1 year; is that correct? In the past we haveten either five or 10-year projections, depending on whether we were getting a five or 10-year budget; is that correct?

Mr. BOLTEN. We have now, for the last couple of years and for many years before that, been doing 5-year budget projections. But I think what you are referring to is that we are, providing less detailed account by account information in future year discretionary expected expenditures.

Senator SARBANES. There was a departure in the budget you submitted this year from past practice, so you are not giving us the projections out beyond just this year, correct?

Mr. BOLTEN. We are giving the projections in broader categories than we have in the past, and if you will give me a moment to explain why.

Senator SARBANES. Would you say it is fair to say it is substantially different from the past?

Mr. BOLTEN. It is different, and the reason why——

Senator SARBANES. That is all I want to know.

Now let me ask the next question. What is the 10-year cost of making the President's tax cuts permanent?

Mr. BOLTEN. I do not have that figure off the top of my head.

Senator SARBANES. Let me try to help you. I have a wonderful chart here of Senator Conrad's.

If you do your 5-year budget, which you are now doing, this is what you show on the cost of the tax cuts. But if we do a 10-year projection of the cost of the tax cuts, look what happens. I think the word up there is "explodes." You get a 1.6 trillion dollar 10-year cost of the Bush tax cuts. Do you quarrel with that figure?

Mr. BOLTEN. I think I do, although I am told that what we are carrying in the budget is $1.1 trillion. But what I would point out is——

Senator SARBANES. Let us do 1.1 trillion. Take that point and proceed on that one. There is a 1.1 trillion dollar cost for the tax cuts, you say?

Mr. BOLTEN. Correct, the extension of the President's, of the existing tax cuts above the current baseline.

Senator SARBANES. Does that include the interest cost on the debt from those tax cuts?

Mr. BOLTEN. It does not.

Senator SARBANES. No. It would be $1.4 trillion roughly if that were included?

Mr. BOLTEN. I do not know, but that would be a substantial increment.

Senator SARBANES. Why do you not submit that for the record?

Mr. BOLTEN. Be glad to.

**Question for the record**
**Senator Sarbanes**
**February 9, 2005**

**Question: What is the 10 year cost with interest of the President's tax cuts?**

Answer: The OMB estimate of the 10-year cost of tax extenders is $1.272 trillion including debt service.

Senator SARBANES. Let me ask you this question. I gather you have cut first responders in this budget by about $1.6 billion from the 2005 level, correct? That is fire and police, first responders.

Mr. BOLTEN. There are reductions in a number of first responder grants, but what we are also increasing on the other side many of the grants that do not just go out by formula to a lot of first responders but are focused on the highest priority homeland security needs. This is what I was trying to get at with Senator Stabenow, which is that we have tough choices to make in the budget, and that is one of the things that we are trying to do with the allocation——

Senator SARBANES. You do indeed have tough choices, and that is the next point I want to make. This is what we figure the cut is to the first responders, 1.6 billion dollars. Now, this big column over here is the cost of the Bush tax cut in 2006 for those making over a million dollars, just the millionaires. The cost of the tax cut they received, $32 billion. What that tells me is if you would just reclaim 5 percent of that wonderful tax cut, 5 percent only, you could fund the first responders. Now, that is priorities. You just said to Senator Stabenow, this is all about priorities, and you have just told me the same thing. It is certainly all about priorities, and there they are. There are the priorities, this excessive tax cut for people making over a million, and we are cutting the first responders, the fire fighters and the police all across the country.

I welcome the formulation because I think it is important to focus on the priorities question, and the priorities question encompasses, in my view, the tax cuts that have been given and who benefits from them, compared with who is impacted and hurt by the spending cuts you are making in this budget.

Thank you very much, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

Senator Wyden.

Senator WYDEN. Thank you. Mr. Chairman, I have always enjoyed working with Mr. Bolten, and he has always been interested in bipartisan approaches and that is what I want to ask about today as it relates to containing the cost in the Medicare prescription drug benefit.

I think people look at this program, and at a time when Senators on both sides of the aisle are up in arms about the costs of the program. People look at the program and are just mystified as to why Medicare is not using the cost containment strategies that are used in the private sector of our country. I have talked with Chairman Gregg about this in the past, but I think it is fair to say, colleagues, that what Medicare is doing as it relates to prescription drugs, is essentially the equivalent of a guy standing in the Price Club and buying one roll of toilet paper at a time. The program is not using the common sense cost containment strategies that are used every day at Goldman Sachs, at timber companies, auto companies and the like.

Now, there is a bipartisan bill that will let us change this, and this is something I want to talk with Chairman Gregg and Senator Conrad about because I have introduced this with Senator Snowe, Senator McCain, and Senator Feingold, my colleague on this committee. It is bipartisan, and allows us to say, at a time when the

costs of this program are going through the stratosphere, that we are going to use not some cost control regime run out of Washington, but private sector bargaining power to control the costs of the program. I mean I do not know of anybody on the planet, Josh—I am going to call you that, we have been known each other a long time—who, when they are buying something in volume and they are going to buy some more of it in volume, does not say, "Hey, pal, how about a discount? Let us negotiate."

So I would like to work with you on it. We have senior Republicans on the Finance Committee, Senator Snowe, Senator McCain, not on the committee but very influential in the health debate, myself, Senator Feingold, my seat mate here. Can we not, at a time when the costs of this program are going through the stratosphere, instead of spending our time wrangling about the numbers—I mean I happen to share Senator Conrad's view about it and Senator Sarbanes—but here we have a chance to do something bipartisan that we can do now to rein in the costs. It is not just the program. We have seen that already the last few days. I mean Lipitor has gone up 5 percent just in the last few weeks, the big cholesterol-fighting drug. Would it not make sense—the number of the bill, in case you want to send us an endorsement letter quickly, is S. 239, Snowe, Wyden, McCain, Feingold and the like. Can we not work together on something like that, to start reining in these costs?

Mr. BOLTEN. Senator, you know I am all about cost containment, so we are glad to talk with you about any proposals that you have. I know Secretary Leavitt will be interested in engaging with you.

Senator WYDEN. So you are open then, Mr. Bolten, to the idea of lifting the restriction? Right now there is in the law a statutory ban that prohibits the kind of cost containment strategy that goes on every day, Goldman Sachs, Weyerhauser, goes on every day in America. I have talked to the chairman about this. It just defies common sense when everybody else in America sits down to buy something they try to get a bargain, they try to get something for it. I would be satisfied today if you would say that you are willing to look at lifting the ban that is now in the law so as to allow us to have private sector cost containment strategies.

Mr. BOLTEN. I am going to leave it, Senator, to Secretary Leavitt to do the actual negotiating with you on this. I do know that the administration has looked at what I think you are referring to, and has relied on CBO and some other estimates that have concluded that the price negotiations would not produce substantial savings to the system, but as the Budget Director, if there are any savings to be captured, I of course do not want to preclude ever having that conversation. My telephone line is always open as you know.

Senator WYDEN. First of all, they actually sent us a revision of that original one and pointed out a situation in particular, sole source drugs, were cost savings, but this is just common sense. I mean, again, it would be one thing if somebody was talking about price controls and having a one-size-fits-all, run from Washington, D.C. kind of program.

I will give you an example.

Chairman GREGG. Senator, we are going to have to——

Senator WYDEN. Can I just finish my thought on this?

Chairman GREGG. Of course, yes.

Senator WYDEN. I appreciate it because we represent a lot of rural communities. In a lot of rural communities there is going to be a fall-back plan, so we will have maybe 1,000 seniors in rural Oregon or New Hampshire, for example, that will have no bargaining power whatsoever to control the costs down. So what Senator Snowe and I want to do is let those seniors in those communities where there is absolutely no leverage whatsoever to hold down the cost of medicine, to be able to pool their power, which everybody does in the marketplace. S. 239, hope we can work together on it.

Thank you for the extra time, Mr. Chairman.

Chairman GREGG. Senator Ensign?

Senator ENSIGN. Thank you, Mr. Chairman. I want to comment quickly on the first responders, and tell you shame on your for trying to eliminate pork. In a lot of these cases, in parts of my State, in parts of States all over this country, that is exactly what a lot of these grants have become. They are not related to terrorism. They are not related to homeland security. Every little community wants something, they want a new fire truck, they want a new this and that. They may be meritorious but they are certainly not related to national security. So I applaud you for that and I think that that needed to be pointed out.

Mr. BOLTEN. Thank you, Senator.

Senator ENSIGN. There are a couple other things that I want to mention about the budget. First of all, you had to provide details to make sure that the number, the top line number that you have is legitimate. That is the reason that you have to put in details. We will disagree sometimes on policy, and you know some of my disagreements with you. We may disagree on specifics but I think the bottom line is that we all agree that we have to get deficits under control.

The major disappointment that I have with this budget is that I do not think it goes far enough on controlling some of the entitlements. I would have liked to have seen a much bolder proposal on health care reforms from the administration. I know the administration does not want to re-open up debates on the new prescription drug program yet. We are going to work with the new Medicare reform law, but I think that there are serious problems. I thought there were serious problems with the bill. I thought there were some really good things in it but there were no real cost controls, especially for lower-income seniors. The copays I believe were too low, and that is going to have to be reviewed. You just raised copays for some veterans and it is something that I think we are going to have to look at, for Medicaid, for Medicare and the like.

But an overall bold health care proposal, some of the things that Senator Enzi and others of us are working on, can save not only Medicare and Medicaid but the whole health insurance system by bringing down costs. Obviously, medical liability reform is very important. Putting in the electronic medical records and going to best practices are as well. The reason it is important for Medicare and Medicaid to adopt these measures is because the insurance industry and the companies that are out there financing health care, will follow Medicare and Medicaid's lead. We will have significant sav-

ings if we adopt some of these reforms. That does not even go to preventative medicine, which I believe in the long run is going to save us a lot of money as well.

Just disappointment there, but I understand you are not a policymaker in that regard. I wish the administration would have been a little bolder in some of the things that they did with respect to health care. I believe this long-term liability is a bigger problem, for our country than even Social Security. Which takes me to my next point: Social Security.

First of all, Senator Stabenow mentioned private accounts. Let us get it straight once and for all, these are not private accounts. This is not privatizing Social Security. They are similar to what we have in the Thrift Savings Plan. All Federal employees including Members of Congress and Senators, can participate in the Thrift Savings Plan. The plan is tightly regulated by the Government. It is not just my own personal Charles Schwab account that I can go out and do with whatever I want. It is very tightly regulated.

I was just talking with someone who was down in Chile when they did this back in 1980. Chile transitioned much faster than we are talking about transitioning. Of all of the index funds that they have, not a single one of them since 1980 has ever lost money. They get a better rate of return. Even if you look at the public employee retirement systems that we have for our State employees across this country, they get a better rate of return. In my State of Nevada, since its inception, FERS has averaged an 11 percent return on their money over a 25-year period of time. That is not too shabby. Even if you take conservative numbers, 5 or 6 percent, that is a lot better than what a younger worker will get back under Social Security. Younger workers can expect a negative return on their money under Social Security. Even if you are optimistic and give them a 1.6 percent return it is nowhere near 5 percent.

So looking at the long-term liabilities, and I think that Senator Crapo addressed this with you, that long-term liability offsetting, should be the bottom line. Let us ask what does the individual get? If the individual is getting more money, they are not getting cut. Whether it is from a private account or the traditional way that we pay out Social Security benefits. The bottom line is if the money is there, they are getting more money for it, that is a pretty good deal for the younger workers. That is why younger people in the United States are really excited about this. We protect older workers, put it in there, and I think that it can be a very good thing.

Would you care to address any of those things that I mentioned? I just wanted to make some of these comments. You can feel free to comment on any of the things I just mentioned.

Mr. BOLTEN. Thank you, Senator. I cannot improve on any of that.

[Laughter.]

Senator ENSIGN. Thank you.

Chairman GREGG. Excellent questions.

[Laughter.]

Senator ENSIGN. I would like to find out more about one of the things that the Director talked about at the beginning. I think would be important for all of us to understand how the PART program works when trying to evaluate whether programs are work-

ing or not. I would like to find out how that works. So if you could get us that and the type of metrics that you are using. I do not think that Congress is using very good metrics in a lot of the things that we are doing. If a program is not measuring up, we need to find out. To do that we need to find out how we are measuring, and not just the number of people going through. For example with a jobs program, are people just going through the program or are they actually getting jobs? I would appreciate the opportunity to learn more.

Mr. BOLTEN. We would be grateful for a chance to brief you in detail and appreciate your interest in it, Senator. Thank you.

Chairman GREGG. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I was sort of amused by Senator Sarbanes' chart up there. I do not think it is entirely accurate. But I think what it does point out is that if we let these temporary taxes expire it will result in the largest tax increase in the history of this country. I just bring up the tax issue, and it seems to me that it has had a positive impact on the economy. We have heard millionaires sort of referred to, but you know, the small business sector, a lot of them have their value, farmers and ranchers have value that puts them over in the millionaire bracket, and they are the producers, but certainly they are the drivers of this economy, and I would like to have you just comment a little bit about what you have seen happen with the tax cuts and how it has motivated Americans to produce and how it has helped to sustain our economy.

Mr. BOLTEN. Senator, the Council of Economic Advisers at the White House and the Treasury Department did a study about the effects of the tax cut, and they concluded that we today, or last year rather, had 3 million more jobs and 3–1/2 percentage points higher gross domestic product than we otherwise would have without those tax cuts. The first charts I put up during my presentation were charts about economic growth in this country and Federal revenues, which is my preoccupation, and I do not believe we would have had that strong economic growth in this country, and I certainly do not believe we would have had the resurgence of Federal revenues absent the strong economic growth that I believe is in large part a product of those very effective tax cuts.

Senator ALLARD. How would you attribute Government spending to economic growth, think that helps any?

Mr. BOLTEN. Most economists will tell you that Government spending, and particularly Government borrowing, is not as useful as money in the private sector, that when we borrow to spend more, that tends to be a net dissavings nationally for the economy. If I can just detour for a second into Social Security and point out one of the things I mentioned in my statement that we have not discussed much here, is that the creation of personal accounts, while it may require some additional Federal borrowing in the short run, does not have that same dissavings effect. It is neutral with respect to national savings because the money is being borrowed by the Federal Government to go into personal accounts which are savings.

So it is very important that we restrain our Federal spending appetite to promote economic growth, but if people are concerned

about the economic effect of creating these personal accounts, that is very different from additional borrowing to spend. The borrowing to create the personal accounts I think is in the long run actually a very good thing for this economy.

Senator ALLARD. My time is starting to run out. One thing I did want to bring up is this, I think you have referred to it as PART. That is Program Assessment Rating and Priority Tool, and you use what we refer to as the GPRA, Government Procedures and Results Act to come up with a test. Can you kind of lay out a little bit how you used this assessment tool to decide which programs are performing and which re not, and maybe use some specific examples if you are prepared to do that?

Mr. BOLTEN. Sure. The Program Assessment Rating Tool asks about 25 different questions. What we are trying to do is assess whether the programs on which we are spending money have clear goals, are they real Federal priorities, is the program being properly managed, and do we have metrics that make it possible for us to assess whether that program is actually performing. Then we do a review, using metrics, to ask, is the program actually performing? So we try to bring all those questions together in a relatively comprehensive and consistent way so we can compare programs, many of which have the same purpose, but do not necessarily have the same effect or the same kind of PART rating. As we put the budget together, one question we have asked consistently and are asking more and more as we put the budget together is, what is the PART rating on the program? Those ratings are and will be available to you as you make your own budgeting decisions, and you will see that many of the programs that the administration is proposing for reduction or elimination are programs with very poor PART ratings.

Senator ALLARD. Are those ratings in the budget that was sent up to the Hill here?

Mr. BOLTEN. I am not sure exactly which document the PART ratings appear in. It is in the document called Analytical Perspectives that you will see the actual PART ratings of the programs, but we are glad to provide additional detail on all of the programs that we have proposed for reduction or elimination, and you will see that many of them are based on poor PART ratings for those programs.

Senator ALLARD. Thank you.

Mr. BOLTEN. Thank you, Senator.

Chairman GREGG. We appreciate your time, Director. There are only three of us left here, and I suspect that Senator Conrad and Senator Sarbanes may have a followup question. Am I right?

[Laughter.]

Chairman GREGG. But we are going to have a vote here, so we will limit those followup questions to 5 minutes too, and essentially the members here, those are the members who will ask the questions, and I will begin.

I want to get back to this issue of tax policy because I look at these suggestions from the other side of the aisle, and basically what they are saying is, "Well, we just have to raise taxes to address the deficit." Of course they also suggest spending money with the taxes they raise. And in fact, I had a chance to study some of

the proposals of the nominee of the Democratic Party on this point, and he suggested that all you had to do was raise the taxes on the top 2 percent of American wage earners or top 10 percent of American wage earners, income brackets, not wage earners. And as a result, you would raise X billions of dollars. Then his proposals came forward, and he spent that plus another trillion dollars. So the debt would have actually increased by about a trillion dollars under the net effect of his proposals. So I guess we await the other side's budget and we will look forward to their proposals and tax increases and their belief that the American taxpayer is under taxed.

But there is also the economic impact. We were confronted with two rather serious events when this President became President. First was a recession which came out of the largest bubble in American history, probably the largest bubble in world history, even bigger than the South Seas Bubble or the Tulip Bubble for all intents and purposes. But we could have expected as a result of that bubble that we would have had an extremely severe recession, but we did not. One of the primary reasons we did not, I believe, was because we cut taxes at the beginning of the recession, which is classic economic reaction to recession, reduce taxes, give people more money to spend, create more economic activity, create more productivity in the marketplace, and it translated into a shallowing out of the recession, which is in turn, as we are now seeing, generating more revenue. You had a very interesting chart there that showed our revenues are now going up rather dramatically, projected to be 9.2 percent this year, 6.5 percent next year, 7 percent projected for the next year. Those are huge increases and jumps in revenue. We are headed back to what is basically the historical revenue of the Federal Government, which will be about 17.9 percent of gross national product with the present tax structure.

So I guess my question to you is if you were to throw a new tax increase on top of this fledgling economy that is growing, this fledgling recovery that we are in, which is becoming fairly robust, would you not expect that that would have a fairly significant dampening effect on our economy, create job loss, probably in the end reduce revenues because you would see reduced economic activity potentially, or certainly slow the rate of growth of revenues?

Mr. BOLTEN. Senator, I am in complete agreement. Our economists believe that a tax increase at this point would be very detrimental to the strong and stable growth that we are projecting out into the future. For our fiscal position, for the positive movement in our deficit picture, the most important thing, the most important element for ensuring that we continue to bring that deficit down is that we realize those relatively strong and stable growth numbers in gross domestic product the you see projected in our budget.

We are projecting growth in the mid 3 to low 3 percent range out over the next 5 years, which is entirely consistent with blue chip expectations. We would not be able to project that growth if in fact we had a substantial tax increase which our economists believe would dig heavily into the economic growth, and as a result, dig heavily into the kinds of revenues we could expect to receive in the Federal Treasury.

Chairman GREGG. I do not want to cut you short but I am running out of time here. The one major tax that needs to be extended,

or one of the major taxes, but the one with the biggest number in this 5-year window—and I accept the argument that when you get outside the 5-years you have the rate issue and you have the death tax issue, but that does not have to be addressed this year. The tax that probably has to be addressed this year is the capital gains and dividends extension. Am I not right, but did not Microsoft just pay out a massive dividend of something like $32 billion, which actually increased Americans incomes significantly. It was a staggering event. Was that not almost purely a function of the fact that we cut the dividend rate back to 15 percent?

Mr. BOLTEN. I believe it was, Senator, and there was an associated increase in gross domestic product as a result of that one-time event. I think it was .1 or .2 percent of GDP that was associated with Microsoft paying that one dividend which I believe was substantially the product of the dividend tax cut that you put into the law a couple of years ago.

Chairman GREGG. So we do need to extend that.

Mr. BOLTEN. I think we do need to extend it. It expires in 2008, so within this budget window, and the cost of extending that is fully reflected in our budget proposals.

Chairman GREGG. Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. I am really glad you started this debate on economics, basic economics. This is where we really do have a disagreement about history and what happened.

This is what CBO told us was the range of possible outcomes for deficits back in 2001 when the administration came in and had a projection of budget surpluses of 5.6 trillion dollars. CBO said this was the possible range of outcomes of budget deficits. Yes, pre-9/11, this was the range of possible outcomes. You know, the CBO and the administration took the midline. That is what led them to believe there were going to be all these surpluses. I warned at the time betting on this was most unwise.

Look at where we came out in terms of the deficits. I tell you, my colleagues on the other side of the aisle, let us revisit history. They told me at the time, “Kent, you are way too conservative. It is not going to be the midline because that does not take account of the tax cuts we are going to put in. The tax cuts are going to unleash this massive increase in revenue. The deficits are not going to be there at all.” I had colleague after colleague on this side of the aisle tell me, “Kent, there is going to be way more money.”

Well, look what happened in the real world. Not a lot more money, a lot less money, the biggest deficits we have ever seen.

Let us have a history lesson what happened with economics in the real world, not in some ivory tower world, in the real world. Back in the 1990’s President Clinton came into office. Here is where outlays were as a percentage of national income. Here is where the revenue was, had an enormous gap, had record budget deficits then, only eclipsed by the deficits we have now. And we put in a plan that reduced the outlays each and every year of the 5-year plan, raised revenue, which according to what you have just said should have tanked the economy. What happened in the real world? Did the economy tank? No.

We had the longest period of economic growth in our Nation’s history. We had the lowest inflation in 30 years. We had the lowest

unemployment in 30 years. We had the highest period of business investment in the Nation's history. That is with reducing spending and increasing revenues and eliminating deficits and eliminating the growth of debt, and stopping, which you acknowledged yourself earlier in your testimony, stopping for 2 years the raiding of Social Security Trust Funds to pay for other things, which would have meant, if that pattern had been continued, we could really have strengthened Social Security by prepaying the liability or paying down the debt.

But those are not the choices that have been made now. Instead here is what happened to spending. We had a tick up, still well below the levels of the 1980's and 1990's. We had a tick up for three primary reasons: defense, homeland security, rebuilding New York, 91 percent of the increase.

Look what happened to the revenue. The revenue collapsed. And you never mentioned the effect of the tax cuts on the revenue collapsing. That is half the reason for this collapse. The other is the economic weakness.

But look where we are. Even with your forecast of where things head in the future with pretty strong economic growth, we have an enormous gap between the spending you advocate and the revenue you advocate. You have deficits that go on forever. Some of us believe that puts our economic strength at risk, that that hurts us, that that will inevitably threaten the United States' position of economic strength in the world. You cannot borrow your way to strength.

One other point I would want to make, I have a few seconds here. Our colleague from Nevada—I wish he was still here—said something that really struck me. He said you never lose money in these TSP like accounts. Whoa. I tell you, I have a lot of people on my staff are going to be surprised by that, because if they started in 2000 they have not made money. I tell you, I lost a lot of money in the TSP account, a lot of money, and so have a lot of other people.

When he said this is all pork that is being cut, look, we have to have cuts, but this is a matter of choices. When you cut the COPS program 96 percent, you are cutting a lot more than pork. That put 100,000 police on the street. When you cut the firefighters 30 percent, that is more than pork. I had the Republican Attorney General of my State come to me, Republican Attorney General, on the question of Byrne grants for law enforcement. I said to him, "You know, the claim will be it is pork. Is it pork?" He said, "Absolutely not. Those Byrne grants are essential to our war on illegal drug use, especially methamphetamines."

Well, I have exceeded my time, Mr. Chairman.

Chairman GREGG. Thank you.

Senator Sarbanes, for the last 5 minutes.

Senator SARBANES. Thank you very much, Mr. Chairman.

Director Bolten, do you think that the increase in defense spending and the increase in homeland security spending contributed to the increase in economic growth in terms of stimulating the economy?

Mr. BOLTEN. I suppose they may have, but money spent in the private sector, most economists agree, is a more effective stimulus to the economy.

Senator SARBANES. That all depends. When yo do a tax cut, people are going to hold on to some of it. They do not spend it all so you do not get 100 percent infusion of that into the economy. On the defense and homeland security spending, just to take those two examples, you do get 100 percent infusion in the first round and then you get the multiplier effect thereafter.

But in any event, even if I want to concede a little bit to your point, the difference is not very great. In other words, if I take someone who is making more than $1 million—and this is income, not wealth, as one of my colleagues said—it is good to hang around here so you can keep clearing up the misconceptions. Let us say I put a surtax on people making more than $1 million in order to fully fund the COPS and the FIRE grant programs, which were established before 9/11. They were not a response to 9/11. They were an earlier response to upgrade our police and fire fighters all across the country, and most observers think they have worked pretty well. I do not know the situation in my colleague's State when he labels it pork, but I know the situation in my own State pretty well and that money has been put to very good use.

If I take some of this money that the millionaires have and fund the police and the fire fighters, in a macroeconomic sense, I am still putting money into the economy, am I not?

Mr. BOLTEN. Most economists would say not nearly as effectively as if you allowed people in the private sector to keep the money on their own, especially if the Federal Government is borrowing that money in order to make expenditures.

Senator SARBANES. Of course you are borrowing it in order to do the tax cuts. Let us address that right now. You are borrowing in order to do the tax cuts. So there is no difference on that point. You say you are borrowing in order to do the spending. You are borrowing in order to do the tax cuts. Let us be clear about that. So the choice becomes, in terms of priorities, what is more important. And second, I would argue that in terms of the macroeconomic impact on the economy there is not much difference.

Do you think paying unemployment insurance has a macroeconomic effect?

Mr. BOLTEN. I am sure it does, Senator. But I think almost——

Senator SARBANES. Do you support it?

Mr. BOLTEN. Sure. But I think almost all economists would agree that Government spending and Government tax cuts are not equal with respect to their effect on the economy. There is a much more stimulative effect to the economy from tax cuts.

Senator SARBANES. I think they would also ask what are you spending the Government money on.

How about Government spending for research and development, what do you think about that as an impetus to the economy?

Mr. BOLTEN. It can be very positive.

Senator SARBANES. It is very important, is it not, for the future? What about Government spending on education?

Mr. BOLTEN. It can also be very positive.

Senator SARBANES. The age cohort in this country that is most in poverty is our youth. That is a sad commentary if you are thinking about the future strength of the Nation. If you look at what other countries are doing that we are engaged with in global competition, they are putting a lot of resources into developing their human resources, the skilled labor force, which our people are going to have to compete with.

So I think we need to strip away from this, first of all, the argument that, in terms of the overall impact on the economy, you do not get that both on the tax side and the spending side. Then you have to make the judgment, which is the better priority? What is your sense of priorities? What does the society need?

I am frank to tell you, I would put as a higher priority educating our children or strengthening our fire and police forces ahead of giving large tax breaks to very wealthy people. That is what has happened. You gave these large tax breaks and you got a deficit out of it.

Thank you.

Chairman GREGG. Do you wish to comment on that, Director?

Mr. BOLTEN. Mr. Chairman——

Chairman GREGG. Or would you rather leave? Which I can understand. You have been very generous with your time.

Senator CONRAD. We do have more questions, Mr. Director.

Chairman GREGG. You have been very generous with your time, and obviously there was a bit of rhetorical——

Mr. BOLTEN. I am always honored to have an opportunity to engage in dialog with the members.

Chairman GREGG. We thank you for your time. We thank your staff for its cooperation with our staff. They have also been very generous with their time.

Tomorrow we will convene here to hear Secretary Snow.

Senator CONRAD. Mr. Chairman, might I just add a final word as well to the director and thank him for his courtesies? We have very real differences and it is important that we debate. Hopefully it never becomes personal, and it certainly has not. I have high regard for you as an individual and for your background. I just wish that you came with a different budget plan for the future.

Mr. BOLTEN. Senator, I appreciate your courtesy and I know we are seeking the same objective if different paths.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Bolton follows:]

**Testimony of OMB Director Joshua B. Bolten**
**President's FY 2006 Budget Request**
**Budget Committee**
**United States Senate**
**February 9, 2005**

Chairman Gregg, Ranking Member Conrad, and distinguished members of the Committee, the President's 2006 Budget, which was transmitted to the Congress on Monday, meets the priorities of the Nation and builds on the progress of the last four years.

We are funding our efforts to defend the homeland from attack. We are transforming our military and supporting our troops as they fight and win the Global War on Terror. We are helping to spread freedom throughout the world. We are promoting high standards in our schools, so that our children gain the skills they need to succeed. We are promoting the pro-growth policies that have helped to produce millions of new jobs and restore confidence in our economy.

Over the past four years, the President and Congress rose to meet historic challenges: a collapsing stock market, a recession, the revelation of corporate scandals and, of course, the terrorist attacks of September 11th.

To meet the economy's significant challenges, in each year of the first term, Congress and the President enacted major tax relief that fueled recovery, business investment, and job creation.

Recent economic indicators support the case for tax relief. Since the recession year of 2001, economic growth has increased in each of the following three years. A primary goal of this Budget is to assure that our economic growth continues.

A strengthening economy produces rising tax revenues. Last year, after declining three years in a row, federal revenue grew by nearly $100 billion. Reflecting strong continued growth, we project that federal revenues will grow by an even larger figure this year.

The President and Congress have also devoted significant resources to rebuild and transform our military, and to protect our homeland. In the first term, the defense budget grew by more than a third, the largest increase since the Reagan Administration. To make our homeland safer, he worked with Congress to create the Department of Homeland Security and nearly triple funding for homeland security government-wide.

While committing these necessary resources to protecting America, the President and Congress have focused on spending restraint elsewhere in the Budget. Working together, we have succeeded in bringing down the rate of growth in non-security discretionary spending each year of the President's first term. In the last Budget year of the previous Administration, non-security discretionary spending grew by 15 percent. In 2005, such spending will rise only about 1 percent. Because of this increased spending restraint, deficits are below what they otherwise would have been.

In order to sustain our economic expansion, we must exercise even greater spending restraint than in the past. When the Federal government focuses on its priorities, and limits the resources it takes from the private sector, the result is a stronger, more productive economy.

The President's Budget proposes that enhanced restraint. The 2006 Budget proposes a reduction in the non-security discretionary category of the Budget. This is the first proposed cut in this non-security spending since the Reagan Administration.

The Budget proposes more than 150 reductions, reforms, and eliminations in non-defense discretionary programs, saving about $20 billion in 2006 alone.

As a result of this enhanced restraint, overall discretionary spending, even after significant increases in defense and homeland security, will grow by only 2.1 percent – less than the projected rate of inflation, which is 2.3 percent. In other words, under the President's 2006 Budget, overall discretionary spending will see a reduction in real terms.

In addition, the Budget also proposes savings from an additional set of reforms in mandatory programs, saving about $137 billion over the next 10 years.

As you well know, both mandatory and discretionary categories of spending are inherently difficult to control, but mandatory programs are especially difficult because of their "auto-pilot" feature. The Administration looks forward to working with the Congress on a package of mandatory savings.

We will also work with Congress on budget process reforms. Last year, I transmitted to Congress, on behalf of the Administration, proposed legislation to establish statutory budget enforcement controls. We plan to transmit a similar set of proposed statutory controls to establish caps on discretionary spending, a pay-as-you-go requirement for mandatory spending only, and a new enforcement mechanism to control long-term unfunded obligations. The President's Budget also proposes that Congress

include these budget enforcement mechanisms and associated reforms in the FY 2006 Budget resolution.

In addition, the Administration proposes other enforcement and budget process reforms, such as the line-item veto, a Results Commission, and a Sunset Commission. These reforms would put in place the tools we need to enforce spending restraint and would bring greater accountability and transparency to the budgeting process.

This Budget restrains spending in a responsible way by focusing on priorities, principles, and performance. We were guided by three major criteria in evaluating programs:

First: Does the program meet the Nation's priorities? The Budget increases funding to strengthen our Armed Forces, improve the security of our homeland, promote economic opportunity, and foster compassion.

Second: Does the program meet the President's principles for the use of taxpayer resources? If an appropriate Federal role could not be identified in a program's mission, the Budget generally proposes to reduce or eliminate its funding.

Third: Does the program produce the intended results? The Bush Administration is comprehensively measuring the effectiveness of the government's programs – and the results are helping us make budgeting decisions. As a part of the President's Management Agenda, the Program Assessment Rating Tool, or PART, was developed to measure the performance of Federal programs. Roughly 60 percent of all Federal programs have undergone the PART, and those scores figured into the budgeting process.

By holding government spending to these accountability standards, by focusing on our priorities, and by maintaining pro-growth economic policies, we are making progress in bringing down the size of the deficit in 2006 and beyond.

Last year's Budget initially projected a deficit of 4.5 percent of Gross Domestic Product (GDP) in 2004, or $521 billion. The President set out to cut this deficit in half by 2009. Largely because economic growth generated stronger revenues than originally estimated, and because the Congress delivered the spending restraint called for by the President, the 2004 deficit came in $109 billion lower than originally estimated.

At 3.6 percent of GDP, the actual 2004 deficit, while still too large, was well within historical range and smaller than the deficits in nine of the last 25 years.

We project the 2005 deficit to come in at 3.5 percent of GDP or $427 billion. If we maintain the policies of economic growth and spending restraint reflected in this Budget, the deficit is expected to decline in 2006 and each of the next four years. In 2006, we project the budget deficit to fall to 3.0 percent of GDP, or $390 billion. In 2007, the deficit is projected to fall further to 2.3 percent of GDP, or $312 billion.

By 2009, the deficit is projected to be cut by more than half from its originally estimated 2004 peak—to just 1.5 percent of GDP, which is well below the 40-year historical average deficit of 2.3 percent, and lower than the deficit level in all but seven of the last 25 years.

The Administration intends to submit shortly a supplemental appropriations request of approximately $81 billion, primarily to support operations in Iraq and Afghanistan for the remainder of the fiscal year. The 2006 Budget's spending and deficit projections fully reflect the outlay effects of this supplemental request, as well as the prior $25 billion supplemental bill already enacted by the Congress. However, the Budget does not reflect the effect of undetermined but anticipated supplemental requests for ongoing operations in Iraq and Afghanistan beyond 2005.

The published version of the 2006 Budget also does not reflect the effects of transition financing associated with the President's proposal to create personal retirement accounts as part of a comprehensive plan to permanently fix Social Security. As the Administration announced last week, the type of personal accounts the President is proposing will require approximately $664 billion in transition financing over the next ten years, with an additional $90 billion in related debt service. This transition financing would result in a deficit in 2009 and 2010 of 1.7 percent of GDP, which is still consistent with the president's goal to cut the deficit in half by 2009, and still well below the 40-year historical average.

It's important to remember that this transition financing does not have the same impact on national savings, and thus on the economy, as does traditional borrowing. Every dollar the government borrows to fund the transition to personal accounts is fully offset by an increase in savings represented by the accounts themselves. In addition, the transition financing of retirement benefits does not represent new debt—these are obligations that the government already owes in the form of future benefits.

Perhaps most important, comprehensive Social Security reform that includes personal accounts can eliminate the system's current $10.4 trillion in unfunded obligations. Those of us who devote our time to thinking about fiscal policy all share a common interest in averting this danger. There is no task as vital to fiscal policymakers this year than removing those unfunded obligations by enacting comprehensive Social Security reform.

Confronting these long-term obligations, combined with our near-term deficit reduction efforts, will help assure a strong economy both now and in the future.

I look forward to working with the committee and Congress on this Budget, which meets the priorities of the Nation in a fiscally responsible way.

Chairman GREGG. Thank you. The hearing is adjourned.
[Whereupon, at 12:10 p.m., the committee was adjourned.]

**Statement of Senator Tim Johnson**

**Senate Budget Committee**

**Senate Budget Committee Hearing: The President's Fiscal Year 2006 Budget Proposal**

**Senate Dirksen Building 608**

**February 9, 2005**

Thank you Chairman Gregg and Ranking Member Conrad for calling today's hearing on the President's proposed Fiscal Year 2006 budget. I appreciate Director Bolten taking the time to explain the assumptions and priorities behind the President's budget and look forward to his answers to the Committee's questions.

For the purposes of my opening statement, I want to train my comments on three parts of the President's budget that I find particularly lacking: the failure of the budget to meet the solemn commitment to our Veterans and the President's cuts to health programs and childhood education.

I was extremely disappointed with the President's budget request for the Veterans Administration (VA), in particular funding for health care for our nation's veterans. The President's budget only provides for a $522 million increase in appropriated funds for VA health care. This is far less than the $3.5 billion increase that veterans organizations say is needed and will not even cover the cost of medical inflation and payroll increases for VA employees. In addition, the President has proposed new user fees and increased co-payments on veterans, a decision that could drive thousands of veterans out of the system. These are fees the Congress has rejected in each of the past two fiscal years.

For me, providing our veterans with quality health care is a moral issue. The men and women who put their lives on the line in defense of this nation should not be told that their health care needs come last. I intend to work with my colleagues to once again restore health care funding for our veterans.

I also have some serious reservations regarding the President's proposals for education funding. For the first time in a decade, education funding would be cut if the President's proposal is enacted. President Bush has again refused to fully fund his own No Child Left Behind Act and underfunds it by $12 billion. While the President's budget increases Title I education by $603 million, for a total of $13.3 billion, it is still $9.4 billion below the level of $22.75 billion he promised when he signed NCLB. Under President Bush's promise when he signed NCLB, South Dakota should receive $69.817 million for Title I in FY06. The President's promise doesn't match his budget priorities because, under his budget, South Dakota would receive $38.255 million for Title I, more than $31 million below the level promised. This would result in 9,882 South Dakota children being denied full Title I services for which they are eligible.

Three months after signing the IDEA Improvement Act, the President ignored the law by underfunding IDEA by $3.6 billion below the FY06 authorized level. The President's budget increases IDEA special education funding by $508 million, for a total of $11.1 billion. Even with this increase it would provide only 18.6% of the national average per-pupil expenditure. This funding level is less than half of the 40% of special education costs the federal government committed to providing in 1975. The federal government's promise to fund 40% of the cost of providing a free and fair public education to disabled students, which was contained the original authorizing legislation, has never been met. I strongly believe it's about time we made good on that promise.

The President's budget proposal for the Department of Housing and Urban Development (HUD) would eliminate and reduce many of the tools South Dakota has available to provide safe and affordable housing in rural America. For the third straight year, the President's budget would eliminate the Rural Economic Development Office within HUD. Last year, I worked with my colleagues to restore funding for this vital program. As well, the proposed budget slashes the Native American Housing Block Grants Program by combining it with the Indian Community Development Block Grant program and cutting their combined budgets by $107 million. I am also worried about language in the budget summary that threatens the viability to the Section 8 Housing Voucher Program, and I will continue to work with my colleagues to ensure that the Section 8 program continues to provide meaningful assistance to those in need of assistance to secure safe, affordable housing.

I am also concerned about the impact the President's budget will have on health programs and, in particular, his proposals to alter the Medicaid program. The President's plan for Medicaid will cut federal spending for the program by $45 billion over the next 10 years, and by over $110 million in South Dakota. This program provides a critical safety-net for our most vulnerable citizens including; seniors in nursing homes, those with catastrophic illnesses, and millions of poor children.

These cuts will have devastating effects in my state. Families USA has estimated that the President's Medicaid plan will cause loss of coverage for 800 elderly people in South Dakota. It will also cut coverage for 4,000 children in South Dakota by 2010; children who would have otherwise been covered under the program if the federal dollars would continue. These are the most vulnerable citizens in my state and have likely sold the farm and exhausted all of their resources just to pay for health care. They are the sickest and the poorest, and this budget proposal tells them that we do not care.

Beyond the devastating effect on those most in need, these proposed budget cuts will inappropriately shift the entire burden of care to already cash-strapped states that are doing everything they can just to get by. The President's budget proposal not only means that many South Dakotans will lose state coverage, but it also means that the state will have to cut services for those who are lucky enough not to be dropped from the Medicaid program. Cuts in services may mean that people on Medicaid will no longer be able to obtain health services such as breast cancer treatment, rehabilitative care or prescription drugs. The impact of these cuts in care will not just go away. Hospitals, health centers and other providers will wind up treating those charity care patients and absorbing those costs. Because care will likely be delayed until a

person needs to go to the hospital that care is going to be much more expensive than if they would have had coverage to go to the doctor or get a prescription drug before getting sick.

Census data has revealed that there were 5.1 million more people uninsured in 2003 than in 2000. This increase is due to loss of employer sponsored coverage, and statistics show that two-thirds of those losing coverage are in low-income jobs. More and more poor people will need programs like Medicaid if the trends continue as they have in recent years. We should be working on solutions to reduce the costs of health care in the United States, but cutting Medicaid is not the answer. We need to closely examine our care system broadly and reduce costs by promoting the use of information technology in health, emphasizing prevention techniques that keep people healthy, and reducing the costs of prescription drugs. This is where the discussion must turn to, rather than placing the blame on the Medicaid program which has been more cost efficient than Medicare or private insurance and has covered millions of Americans most in need.

Russ Feingold

Statement of Senator Russ Feingold
February 9, 2005

Mr. Chairman, thank you for calling this hearing today. We find ourselves in a real budget mess. Some of it is the result of events we did not foresee, but most of it results from policies proposed by the Administration and enacted by Congress.

The President, in offering this budget, states that reducing the deficit is now a priority. It is a bit like hearing the farmer bemoan the loss of his horses after having opened every door to the barn and driven them out. Nevertheless, I welcome the Administration's statements about our fiscal position, however late they have been in emerging. We are more likely to actually begin cleaning up the fiscal mess if Congress and the Administration admit there is a problem.

One must question, however, just how serious the Administration is about cleaning up the fiscal mess it was so instrumental in creating. The document that the President has sent us doesn't come close to describing the real problem we face. As others have noted, the President failed to include a number of his policies that will have a massive fiscal impact on the budget.

Every administration plays some hide and seek with their budget. But the scale of the mischief in this budget is overwhelming.

The President failed to include the ongoing costs of the War in Iraq. He failed to include the cost of fixing the Alternative Minimum Tax problem, which we know is about to explode. He failed to include the cost of the centerpiece of his second term, his proposal to privatize Social Security. And by only offering a 5-year budget, he has hidden the enormous out year costs of making the 2001 and 2003 tax cuts permanent.

When the Defense Secretary Donald Rumsfeld was talking about the defense budget request the other day he said, "The only way you can look at this budget is to look at the supplementals."

I regret to say that he is absolutely right. The defense provisions submitted by the President in his budget are only part of the story because the Administration has chosen, once again, to hide the true costs of ongoing operations in supplementals - a budgeting device meant only for unanticipated, unforseen costs.

Mr. Chairman, how is the construction of the U.S. embassy in Iraq an unanticipated cost? How are the Army's "modularity" efforts an unanticipated cost? It is quite clear that the Administration is using the supplemental appropriations process in part as a tool to obscure overall defense spending and to isolate programs from the tough budget

decisions we must make to balance the budget.

I wrote to the President last year to urge him to include the costs of operations in Iraq and Afghanistan in the regular budget. I reminded the President that the fiscal year 2005 Department of Defense Appropriations Act that he signed into law required thorough reporting of the ongoing costs and detailed estimates of anticipated costs.

The Senate also stated unequivocally in that same law that the costs of Iraq and Afghanistan should be included in the regular budget. I am deeply disappointed that the Administration has chosen to ignore the Senate.

As I noted earlier, there are other examples of this budgeting shell game, and the Administration has offered a number of explanations. My favorite may be from Tuesday's Washington Post. In explaining why the President's massive Social Security proposal was not included in his budget, we were told that the "budget went to bed . . . before the president's proposals were announced."

The budget went to bed before the proposal was announced, Mr. Chairman. Rather than asking some folks to go back and rouse the budget "out of bed" in order to add the centerpiece of the President's agenda, the Administration decided to send Congress a document that does not reflect the President's true budget.

Mr. Chairman, it appears that there are two sets of books. The set shown to Congress and the public, and the other set, the one with the real numbers. I don't suppose it would do any good for us to demand the real books. I suspect some may not want to see them.

The fiscal mess we face is much worse than the President would have us believe, and we need to face up to that.

Having said that, I do want to indicate that I support many of the proposals the President makes to cut spending. Some are similar to proposals for which I have fought. There are areas in which we need to go further than the President. While I am pleased he has begun to question some of the incredibly expensive weapons systems in the Defense budget, we need to do more. Many of these systems have no relevance to our very pressing security needs.

I was pleased to see the President propose to trim the expensive Army Corps of Engineering projects budget, but here again we need to go much further. We should deauthorize the $50 billion backlog of projects, reduce the federal cost share for Corps projects, and require an independent review of projects to ensure they are economically

justified. We should also require that the cost-benefit ratio for Corps projects be 1 to 1 ½. Taxpayers should, at the very least, get $1.50 in benefits for every $1.00 they pay into a Corps project. If we do those things, we can save taxpayers $60 billion. I will be introducing a bill to do just that, and I hope the Administration will support that effort.

Mr. Chairman, I thank you again for convening today's hearing. I hope that by the time this budget is out of the Committee that we will see a more complete version of the President's budget proposal. When we do, I think Members will realize just how big a task we have before us.

**Questions from Senator Kent Conrad**
**Senate Budget Committee Hearing**
**OMB Director Josh Bolten**
**February 9, 2005**

Question: **The President's budget claims to eliminate or cut more than 150 programs. Please provide to the committee a list of the 150 programs for the hearing record.**

Answer: Note: Please refer to the publication "Major Savings and Reforms in the President's 2006 Budget," which may be found on the web at:
www.whitehouse.gov/omb/budget/fy2006/pdf/savings.pdf

**Summary of Discretionary Terminations in the FY 2006 Budget**
(Budget authority in millions)

| Terminations | Has the termination been proposed before? 2002 | 2003 | 2004 | 2005 Request | 2005 Enacted | 2006 Request |
|---|---|---|---|---|---|---|
| **Department of Agriculture** | | | | | | |
| AMS Biotechnology Program | N | N | N | 4 | 4 | --- |
| Forest Service Economic Action Program | N | Y | Y | --- | 19 | --- |
| High Cost Energy Grants | Y | Y | Y | --- | 28 | --- |
| NRCS Watershed and Flood Prevention Operations | N | Y | N | 40 | 75 | --- |
| Research and Extension Grant Earmarks and Low Priority Programs | Y | Y | Y | --- | 180 | --- |
| **Total, Agriculture Terminations** | | | | **44** | **306** | **---** |
| **Department of Commerce** | | | | | | |
| Advanced Technology Program | Y | N | Y | --- | 136 | --- |
| Emergency Steel Guarantee Loan Program | Y | Y | Y | -35 | --- | -50 |
| Public Telecommunications Facilities, Planning and Construction Program | N | N | Y | 3 | 21 | 2 |
| **Total, Commerce Terminations** | | | | **-33** | **157** | **-48** |
| **Department of Education** | | | | | | |
| Comprehensive School Reform | N | N | Y | --- | 205 | --- |
| Educational Technology State Grants | N | N | N | 692 | 496 | --- |
| Even Start | N | N | N | --- | 225 | --- |
| High School Program Terminations: | | | | | | |
| Vocational Education State Grants | N | N | N | 1,000 | 1,194 | --- |
| Vocational Education National Activities | N | N | Y | --- | 12 | --- |
| Tech Prep State Grants | N | N | Y | --- | 106 | --- |
| Upward Bound | N | N | N | 316 | 313 | --- |
| Talent Search | N | N | N | 146 | 145 | --- |
| GEAR UP | N | N | N | 298 | 306 | --- |
| Smaller Learning Communities | Y | Y | Y | --- | 94 | --- |
| Perkins Loans: Capital Contributions and Loan Cancellations | N | N | N | 66 | 66 | --- |
| Regional Education Laboratories | N | N | Y | --- | 66 | --- |
| Safe and Drug Free Schools State Grants | N | N | N | 441 | 437 | --- |
| Small Elementary and Secondary Education Programs: | | | | | | |
| Javits Gifted and Talented Education | Y | Y | Y | --- | 11 | --- |
| National Writing Project | Y | Y | Y | --- | 20 | --- |
| School Leadership | -NA- | Y | Y | --- | 15 | --- |
| Dropout Prevention Program | -NA- | Y | Y | --- | 5 | --- |
| Close Up Fellowships | Y | Y | Y | --- | 1 | --- |
| Ready to Teach | Y | Y | Y | --- | 14 | --- |
| Parental Information and Resource Centers | Y | Y | Y | --- | 42 | --- |
| Alcohol Abuse Reduction | -NA- | Y | Y | --- | 33 | --- |
| Foundations for Learning | -NA- | -NA- | -NA- | --- | 1 | --- |
| Mental Health Integration in Schools | -NA- | -NA- | -NA- | --- | 5 | --- |
| Community Technology Centers | Y | Y | Y | --- | 5 | --- |
| Exchanges with Historic Whaling and Trading Partners | -NA- | Y | Y | --- | 9 | --- |
| Foreign Language Assistance | Y | Y | Y | --- | 18 | --- |
| Excellence in Economic Education | -NA- | N | N | --- | 1 | --- |
| Arts in Education | Y | Y | Y | --- | 36 | --- |
| Women's Educational Equity | Y | Y | Y | --- | 3 | --- |
| Elementary and Secondary School Counseling | Y | Y | Y | --- | 35 | --- |
| Civic Education | Y | Y | N | --- | 29 | --- |
| Star Schools | Y | Y | Y | --- | 21 | --- |
| Smaller Higher Education Programs: | | | | | | |
| Higher Education Demos for Students w/Disabilities | Y | Y | Y | --- | 7 | --- |
| Underground Railroad Program | Y | Y | Y | --- | 2 | --- |
| Interest Subsidy Grants | N | N | N | --- | 1 | --- |
| Small Job Training and Adult Education Programs: | | | | | | |
| Occupational and Employment Information | Y | Y | Y | --- | 9 | --- |
| Tech-prep Demonstration | Y | Y | Y | --- | 5 | --- |
| Literacy Programs for Prisoners | N | Y | Y | --- | 5 | --- |
| State Grants for Incarcerated Youth | N | Y | Y | --- | 22 | --- |
| Small Postsecondary Student Financial Assistance Programs: | | | | | | |
| LEAP | Y | Y | Y | --- | 66 | --- |
| Byrd Scholarships | N | N | N | 41 | 41 | --- |
| B.J. Stupak Olympic Scholarships | Y | Y | Y | --- | 1 | --- |
| Thurgood Marshall Legal Opportunity | Y | Y | Y | --- | 3 | --- |
| Small Vocational Rehabilitation Programs: | | | | | | |
| Vocational Rehabilitation Recreational Programs | N | Y | Y | --- | 3 | --- |
| Vocational Rehab. (VR) Migrant and Seasonal Workers | N | Y | Y | --- | 2 | --- |
| Projects with Industry | N | Y | Y | --- | 22 | --- |
| Supported Employment | N | Y | Y | --- | 37 | --- |
| Teacher Quality Enhancement Program | N | N | N | 89 | 68 | --- |
| **Total, Education Terminations** | | | | **3,089** | **4,263** | **---** |

**Summary of Discretionary Terminations in the FY 2006 Budget**
(Budget authority in millions)

| Terminations | Has the termination been proposed before? 2002 | 2003 | 2004 | 2005 Request | 2005 Enacted | 2006 Request |
|---|---|---|---|---|---|---|
| **Department of Energy** | | | | | | |
| Hydropower Program | N | N | N | 6 | 5 | — |
| Nuclear Energy Plant Optimization | N | Y | Y | — | 2 | — |
| Nuclear Energy Research Initiative | N | N | Y | — | 2 | — |
| Oil and Gas Programs | Y | Y | Y | 41 | 79 | 20 |
| **Total, Energy Terminations** | | | | **47** | **88** | **20** |
| **Health and Human Services** | | | | | | |
| ACF Community Service Programs | N | N | N | 5 | 30 | — |
| ACF Early Learning Opportunities Fund | Y | Y | Y | — | 35 | — |
| CDC Congressional Earmarks | Y | Y | Y | — | 60 | — |
| CDC Preventive Health and Health Services Block Grant | N | N | N | 132 | 131 | — |
| CDC Youth Media Campaign | N | N | N | 4 | 59 | — |
| Direct Service Worker Delivery Grants | N | N | N | 3 | 3 | — |
| HRSA Emergency Medical Services for Children | N | N | N | 20 | 20 | — |
| HRSA Health Facilities Construction Congressional Earmarks | Y | Y | Y | — | 476 | — |
| HRSA Healthy Community Access Program | Y | Y | Y | 10 | 82 | — |
| HRSA State Planning Grant Program | N | Y | Y | — | 11 | — |
| HRSA Trauma Care | N | Y | Y | — | 3 | — |
| HRSA Traumatic Brain Injury | N | N | N | 9 | 9 | — |
| HRSA Universal Newborn Hearing Screening | N | Y | Y | — | 10 | — |
| Real Choice Systems Change Grants | N | N | N | 40 | 40 | — |
| **Total, HHS Terminations** | | | | **224** | **970** | **—** |
| **Department of Housing and Urban Development** | | | | | | |
| HOPE VI | N | Y | Y | — | 143 | -143 |
| **Total, Terminations** | | | | **—** | **143** | **-143** |
| **Department of the Interior** | | | | | | |
| BLM Jobs-in-the-Woods Program | N | N | N | 6 | 6 | — |
| LWCF State Recreation Grants (NPS) | N | N | N | 91 | 90 | — |
| National Park Service Statutory Aid | N | N | N | — | 11 | — |
| Rural Fire Assistance (BLM, NPS, FWS, BIA) | N | N | N | 5 | 10 | — |
| **Total, Interior Terminations** | | | | **102** | **117** | **—** |
| **Department of Justice** | | | | | | |
| Byrne Discretionary Grants | Y | Y | Y | — | 168 | — |
| Byrne Justice Assistance Grants | N | N | N | 528 | 626 | — |
| COPS Hiring Grants | N | N | N | — | 10 | — |
| COPS Interoperable Communications Technology Grants | Y | Y | Y | — | 99 | — |
| COPS Law Enforcement Technology Grants | N | N | N | — | 137 | — |
| Juvenile Accountability Block Grants | N | N | Y | — | 54 | — |
| National Drug Intelligence Center** | N | N | N | 35 | 39 | 17 |
| Other State/Local Law Enforcement Assistance Program Terminations | N | N | N | 30 | 94 | — |
| State Criminal Alien Assistance Program (SCAAP) | N | Y | Y | — | 301 | — |
| **Total, Justice Terminations** | | | | **593** | **1,528** | **17** |
| **Department of Labor** | | | | | | |
| Migrant and Seasonal Farm Worker Training Program | N | Y | Y | — | 76 | — |
| Reintegration of Youthful Offenders | Y | Y | Y | 55 | 50 | — |
| **Total, Labor Terminations** | | | | **55** | **126** | **—** |
| **Department of Transportation** | | | | | | |
| National Defense Tank Vessel Construction Program | N | N | N | — | 74 | — |
| Railroad Rehabilitation Infrastructure Financing Loan Program | N | N | N | — | -NA- | -NA- |
| **Total, Transportation Terminations** | | | | **—** | **74** | **—** |
| **Enviromental Protection Agency** | | | | | | |
| Unrequested Projects | Y | Y | Y | — | 489 | — |
| Water Quality Cooperative Agreements | N | N | N | 21 | 17 | — |
| **Total, EPA Terminations** | | | | **21** | **506** | **—** |
| **National Aeronautics and Space Administration** | | | | | | |
| Hubble Space Telescope Robotic Servicing Mission | N | N | N | 30 | 291 | — |
| **Total, NASA Terminations** | | | | **30** | **291** | **—** |
| **Other Agencies** | | | | | | |
| National Veterans Business Development Corporation | N | N | N | 2 | 2 | — |
| Postal Service: Revenue Forgone Appropriation | N | N | N | — | 29 | — |
| SBA: Microloan Program | N | N | N | — | 15 | — |
| SBA: Small Busines Investment Company (SBIC) Participating Securities Program | N | N | N | — | — | — |
| **Total, Other Agency Terminations** | | | | **2** | **46** | **—** |
| **TOTAL, Terminations** | | | | **4,174** | **8,614** | **-154** |

**Question from Senator Mike Crapo**
**Senate Budget Committee Hearing**
**OMB Director Josh Bolten**
**February 9, 2005**

**Question: The budget proposes to shift funds from the Hatch Act, McIntire-Stennis Cooperative Forestry, and Animal Health and Disease Research Programs to competitive grant programs.**

**Are you asserting that funds allocated to ~~schools based~~ on a formula are not allocated to research on a competitive basis?**

Answer: The Administration strongly believes that the most effective use of taxpayer dollars for research grants is through a competitive, peer review process that is open to all applicants. By contrast, formula funds are allocated only to those institutions authorized by law to receive the funds. In addition, the great majority of these funds are provided to those institutions through a predetermined methodology that is based primarily on historical data, rather than using a measurement based on quality.

**Question: The funds provided under these formula-based research grant programs are highly leveraged, what is the justification for why the funds are not necessary?**

Answer: The FY2006 Budget states that the highest quality research is generated through a competitive process that is open to all institutions and individuals and that considers the ability of the requester to have the infrastructure in place to carry out the research proposal. In times of constrained funding, it is even more critical that limited taxpayer dollars be allocated to achieve the highest quality results. We believe that the most important criterion is that funding is used to support the highest quality research possible, and we believe that open competition for research funding will encourage leveraging.

**Question: Have you considered the impact of the phase out of the formula-based grants on the research infrastructure?**

Answer: The Administration believes the proposal to increase the National Research Initiative and create a new competitive research program for regional, State and local needs, and the phase out of these formula programs will strengthen the agriculture research infrastructure. The additional $145 million of competitive funding, which will allow for larger grants, as well as the elimination of the lower indirect cost cap, will attract the best scientists to agricultural research.

**<u>Question:</u> Did you consult with any Agriculture or Natural Resource Deans or land grant universities about this proposal and the disruption that it is likely to cause?**

<u>Answer:</u> The Administration heard the general concerns raised by the agricultural research community that funding for the NRI needed to be increased and the current ceiling on indirect costs was making it difficult to attract the best scientists to work in agriculture. Therefore, the proposal includes additional competitive research funding and the elimination of the current cap on indirect costs. We intend to seek the advice and expertise of the university research community in particular as the proposal is fine-tuned and phased in during the next two years.

**Question:** **The budget proposes phasing out support for Resource Conservation and Development (RC&D) councils. The decision to phase out funding was due in part to a 2005 PART assessment. Does that analysis take into account the local grassroots decision-making process in determining priorities and targeting funding?**

Answer: Through the PART assessment, the Administration evaluates a program's purpose, strategic goals, management, and performance. Local decision making processes and priority setting was evaluated as part of strategic planning assesment. The program scored 50 percent on this element of the PART.

The primary issue is that the program does not have clearly defined goals and is not able to adequately measure performance. In addition, over half of the existing RC&D councils have received Federal assistance for more than 20 years, and in many instances councils have received Federal dollars for more than 30 or even 40 years. By now, these local councils should have the necessary experience and capability to identify concerns and deliver improvement projects without the continued need for a USDA staff person.

**Question:** **Did you measure the progress local RC&D councils were making on implementing their area strategic plans prior to making this decision?**

Answer: The Administration did consider the program's performance assessment system and found that the RC&D program is currently not able to comprehensively assess how well the councils are performing. While the program can provide general information on the number of projects completed, the program cannot yet meaningfully measure outcomes that are directly attributable to the RC&D program.

**Question:** **Was the record of achievement of local councils taken into account when you made the recommendations?**

Answer: The Administration's budget proposal recognizes that the RC&D program improves local capability to identify concerns and deliver improvement projects. As explained above, over half of the current RC&D areas have received Federal assistance for more than 20 years. Because these experienced councils have demonstrated that they can plan for and help to deliver projects, it is less apparent why these local communities should continue to receive assistance from a USDA employee. However, these local councils can continue to apply for federal program and project assistance from a variety of conservation and rural development programs.

**Question: RC&D leverages $6 from other sources to every $1 the federal government invests. Was consideration given to this in your budget decision making process?**

Answer: The RC&D councils do help to coordinate funding for conservation and community development projects from a variety of sources. For the past several years, with the help of USDA resources, the councils derived almost a third of their project funding from other Federal programs. Indeed, the councils' ability to apply for funding and coordinate dollars from other Federal, State, and local government agencies and private organizations underscores the Administration's finding that these local councils have the necessary experience and capability to deliver their own projects.

**Question: What efforts were taken to consult with local councils in this budget decision?**

Answer: The Administration's internal budget deliberations included input from federal staff that has both knowledge of the program as well as experience working with the local RC&D councils. As the Administration and Congress continue to discuss the development and implementation of the 2006 Budget, we welcome additional information and recommendations from local councils and the public for improving the accountability and performance of the RC&D program.

**Question: The President's budget proposes reducing the payment limit cap for individuals to $250,000. The budget also proposes the removal of the "three entity rule." Congress tasked the Commission of the Application of Payment Limits to Agriculture with analyzing the issue of payment limitations. In September of 2003, the commission reported that no payment limit changes should be made before the next Farm Bill. Did the Administration take the commission's report into account when making this proposal?**

**Have you estimated the additional costs of administering the Administration's payment limit proposals? Have you estimated the cost to the private sector of complying with the new proposals and the possible disruption of orderly marketing and lost markets that may result from complying with the new proposals?**

Answer: The Administration took the recommendations of the Commission on the Application of Payment Limits to Agriculture into account when developing the budget proposal. The proposals to tie payments to a farmer's personal social security number and to strengthen the current criteria for determining eligibility of persons for payments are both recommendations of

the Commission. The additional costs of administering the Administration's payment limitation proposal is included in the Farm Service Agency's budget and is expected to be minimal. The Administration acknowledges that there will be monetary and indirect costs to the private sector of complying with the proposal.
The Administration will endeavor to minimize the cost and disruption associa ted with any change to the payment limit.

**Question: The President's budget proposes a 1.2 percent marketing assessment on sugar processors. Prior to proposing this assessment did the Administration consider the economic impact the marketing assessment would have on the sugar industry? What is your justification from imposing what appears to be a new tax on an already struggling sugar industry?**

Answer: Yes, the Administration considered the impact the assessment would have on the sugar industry. The assessment would cost the industry roughly $42 million in 2006, or roughly 2.6 percent of processors' revenue for the year. The sugar industry benefits greatly from Government policies. The Administration's proposal for agriculture is part of the President's effort to exercise responsible spending restraint. The proposal does not target any specific commodity or region and is designed to be equitably spread across the agricultural sector.

<u>Question:</u> **I am concerned with the proposal in the budget to treat Bonneville Power Administration's (BPA) nontraditional financing transactions as debt counted toward its statutory debt limit. I would like more clarification on what transactions would be affected. Would refinancing of existing debts, such as BPA's nuclear debt, be counted against this new debt limit?**

**Would agreements like BPA's recently signed settlement to provide financial benefits to the residential customers of the region's investor-owned utilities count against this new debt limit?**

<u>Answer:</u> No, refinancing existing nuclear and other debt would not count as additional debt against the debt limit. Only if BPA used a portion of refinancing proceeds to expand its assets would the incremental amount be added toward its debt limit.

In addition, the recent residential customer settlement would not count against the new debt limit, nor would commitments by BPA to purchase power on a long-term basis unless cash or another asset was advanced to BPA in exchange for the commitment.

**Can you provide any assurance that if the proposal went forward that BPA will have access to the capital necessary to maintain regional electrical reliability?**

<u>Answer:</u> The Administration's proposal is not intended to and would not restrict BPA's access to capital. It is intended to appropriately record BPA's alternative financing transactions as a form of debt against its statutory debt limit because, like debt, these long-term transactions result in liabilities that make a claim on future agency resources. Adopting the proposal would make Bonneville's debt cap meaningful again by capturing all relevant ratepayer and taxpayer liabilities. In addition, the Budget proposes to increase BPA's debt limit by $200 million, which exceeds the additional transactions identified by BPA that would be categorized as debt by the legislation.

<u>Question:</u> **Will you commit to working with me prior to forwarding any legislative proposal to Congress?**

<u>Answer:</u> The Administration is eager to work with you and other interested parties.

<u>Question:</u> **I am concerned with the proposal in the budget to bring Power Marketing Administration's (PMA) electricity rates closer to average market rates.**

**Under the proposal, how much of an increase do you anticipated ratepayers in the Pacific Northwest will face in the first year?**

Answer: The budget projection is that $23 million would be derived from BPA power sales in the Northwest. Based on EIA estimates of sector usage of electricity, about 40 percent is derived from commercial/industrial users, and the remainder from households. Assuming the increase is passed along to all consumers, this would total less than 45 cents per month per household.

<u>Question</u>: **Do you agree that affordable electricity rates are important to economic growth?**

<u>Answer:</u> Yes, affordable electricity is important to the economies of all areas of the country, but its impact on economic growth is generally small relative to other factors, such as interest rates that can be influenced by the size of the Federal deficit.

<u>Question:</u> **Are you aware of the 1996 Bonneville Appropriations Refinancing Act and the $100 million BPA ratepayers paid to reconstitute the debt owed to the Treasury?**

<u>Answer:</u> Yes, in fact, the GAO commented on the Act in one of its reports, noting that under the restructuring more than $2.5 billion of BPA's appropriated debt was written off. In exchange for the write-off, the interest rates on BPA's lower debt balance were reduced to then-current Treasury interest rates. BPA also agreed to pay an additional $100 million over the remaining terms of the debt. Other than this $100 million, the net cash flow to the Treasury was essentially unchanged as a result of the restructuring. Thus, according to GAO, the taxpayer subsidy to BPA ratepayers continues as long as the appropriated debt and the corresponding Treasury debt are outstanding.

<u>Question:</u> **Are you aware of the provision directing BPA to offer to include in its contracts language specifying that rates and charges shall be based on the interest rates established under that act for repaying BPA's old appropriated debt?**

Yes. In 1996, responding to criticism that BPA's debt interest rate was subsidized, Congress enacted legislation intended to remove this BPA subsidy. The legislation forgave $2.6 billion of BPA's debt owed to the

Treasury in exchange for refinancing BPA's appropriated Treasury debt at Treasury's then "yield curve" rates. The legislation reset the interest rate on BPA's outstanding appropriated debt at the prevailing Treasury rate (about 7. 1 percent) at the end of FY 1996. BPA's debt payments remained the same as before the debt forgiveness/refinancing, but more was allocated to interest expense.

This Act also required BPA to stipulate certain contract terms in all future and some existing contracts for the sale of electric power, transmission or related service. Stipulated terms include: 1) When the Administrator establishes rates, the principal and interest on old capital investments shall be no greater than established under the BPA Refinancing Act and credit shall be given to all payments by the Administrator of principal and interest on the old capital investments; 2) Only the reset principal and interest, and nothing else, may be charged on old capital investments; 3) The Judgment Fund shall be the source of payment if these provisions are breached. The Administrator's existing ratemaking authority to allocate costs and design rates was maintained.

**Question: The President's budget requests a total of $730 million for capitalization grants for the Clean Water State Revolving Funds and $850 million for Drinking Water State Revolving Funds. The former is a $370 million reduction from the current fiscal year and $120 million less than the President's request for Fiscal Year 2005.**

**At the same time, the EPA 2002 Water Infrastructure Gap Analysis highlights the enormous challenge of funding shortfalls to meet the infrastructure needs of the next 20 years. The analysis suggests that additional local revenues will help address much of the shortfall, but does not address the probability of dramatic revenue increases. If these additional revenues do not materialize, states and localities will be looking into the Revolving Funds to fulfill a major portion of the shortfall.**

**Question: How are the funding levels requested, and the reductions in Clean Water SRF allocations in particular, consistent with that situation?**

Answer: The Administration took into consideration the findings of EPA's water infrastructure gap analysis when revising the previous Administration's funding policy for the Clean Water SRF. Accordingly, the 2004 Budget extended Federal capitalization of the Clean Water SRF through 2011, and committed to providing an additional $6.8 billion in total capitalization over the previous Administration's policy. In 2004 and 2005, Congress provided

significantly more for the Clean Water SRF than requested (+$492 million and +$241 million, respectively). Because of these increases, the program needs less funding than in previous years to meet the Administration's Federal capitalization target of $6.8 billion.

**Question: What is the expected future commitment to the two SRF programs?**

Answer: As mentioned in the previous answer, the Administration has committed to providing $6.8 billion in total capitalization for the Clean Water SRF from 2004 through 2011. The Administration has also committed to providing $850 million annually for the Drinking Water SRF through 2018.

**Question: At what level of revolution does the EPA estimate the funds will operate after that future commitment?**

Answer: The additional capitalization for the Clean Water SRF will result in an average annual revolving level of $3.4 billion after Federal funding ends. This represents a significant increase over the previous Administration's revolving level target of $2 billion annually. The Administration's commitment to the Drinking Water SRF will result in an average annual revolving level of $1.2 billion after Federal funding ends.

**Question from Senator Pete V. Domenici**
**Senate Budget Committee Hearing**
**OMB Director Josh Bolten**
**February 9, 2005**

**Question: I understand that the President has reaffirmed his commitment to open a small portion of the Arctic National Wildlife Refuge—or ANWR—to oil and gas exploration. In a time of extraordinary dependence upon foreign sources of oil from politically unstable regions, this seems absolutely sound policy.**

**I believe that only if this Committee produces a reconciliation instruction ordering ANWR exploration, and related receipts, will we be able to carry out this portion of the President's budget.**

**Is the President's commitment to ANWR absolute? And, how much would it add to the deficit if we failed to pass the ANWR initiative?**

Answer: The President strongly supports the authorization of environmentally responsible oil and gas exploration and development in a small portion of the Arctic Refuge. The Administration has consistently supported provisions authorizing ANWR exploration as part of broader energy legislation in the last Congress. The President continues to encourage Congress to pass comprehensive energy legislation, but would also support the necessary authorization for ANWR in a reconciliation bill.

The President's Budget assumes that, if authorized, the first lease sale in ANWR would take place in 2007 and would generate $1.2 billion in federal revenues (with another $1.2 billion going to the State of Alaska). Actual production would not occur until 2015. The Budget assumes that over the next 10 years, federal revenues from ANWR would generate $1.5 billion that would be applied toward deficit reduction.

**Question: The budget message highlights the development of "diverse, safe, affordable, and reliable sources of energy" as an important part of the President's six-point plan for promoting economic prosperity.**

**Last year, the Congress did not complete action on the comprehensive energy policy bill, although several tax-related provisions were enacted.**

**What does the President's FT 2006 budget include for new energy bill, and what are the components of the request?**

**I note that the Administration has again submitted various energy tax proposals and the proposal to open a specific small area of the Arctic National Wildlife Reserve—or ANWR—for energy exploration. What are the other items in the President's FY 2006 budget that would be considered part of a comprehensive energy plan?**

Answer: The energy components of the 2006 Budget that require legislative action include: energy tax incentives totaling $6.7 billion over ten years (2006-2015), to diversify our power supply and reduce dependence on foreign supplies; authorizing the Department of the Interior to conduct environmentally responsible oil and gas exploration and development within a small area of the Artic National Wildlife Area; clarifying that limitations on Tennessee Valley Authority (TVA) and Bonneville Power Administration (BPA) debt should include "alternative financing" transactions that constitute agency debt; increasing BPA's debt limit by $200 million in 2009; authorizing Federal Energy Regulatory Commission jurisdiction over TVA electricity transmission to the same extent as public utilities; and allowing the Power Marketing Administrations to gradually increase power sale prices to market levels.

**Question: The President's FY 2006 budget includes tax proposals to increase energy production and promote energy conservation that would reduce receipts to the federal Treasury totaling $4.5 billion over five years, and $6.7 billion over ten years.**

**These proposals will be considered by Congress this year as it begins work on the budget resolution and on energy policy legislation.**

**Last year's tax bill that was enacted included several energy tax provisions, including incentives for alcohol and biodiesel fuel, the biodiesel income tax credit, and the oil and gas production tax credit for marginal wells.**

**Are the tax proposals submitted by the President this year, the same tax provisions that were proposed in his national energy policy two years ago?**

Answer: Yes, the 2006 Budget includes energy tax proposals recommended in the 2001 National Energy Policy report and in past Budgets. The Administration believes that these proposals provide important incentives to diversify our power supply and reduce dependence on foreign energy

supplies, and are fiscally prudent given the President's focus on reducing the deficit.

**Are these energy tax proposals still a priority for the Administration as it emphasized the need for a comprehensive national energy policy?**

Answer: Yes, the energy tax provisions in the 2006 Budget address priority needs while maintaining fiscal discipline.

**Question: I am pleased to see that the Administration requested sufficient funding for the Department of Energy to proceed to develop the nuclear waste repository at Yucca Mountain in Nevada.**

**The FY 2006 budget includes $651 million in appropriations for activities associated with the Yucca Mountain programs.**

**The Administration did not resubmit its proposal to reclassify fees paid by nuclear utilities into the U.S. Treasury from mandatory spending to discretionary amounts to offset appropriations for the program. That proposal left about a $750 million hole in my Energy and Water Development Appropriations bull that delayed action until the eleventh hour of the last Congress.**

**What activities does the Administration expect to undertake to advance the Yucca Mountain project in FY 2006 with the $651 million that is requested?**

Answer: During FY 2006, the Department of Energy plans to complete the license application for authorization by the Nuclear Regulatory Commission to construct a permanent geologic repository for the Nation's nuclear waste at Yucca Mountain, Nevada. Funds will also be used to resume design activities for the National Transportation Program, including procuring prototype rail cars and supporting critical engineering and design work for the Nevada rail line and associated support facilities.

The Administration continues to believe that the fees utilities pay to the Government to finance the repository should be treated as offsetting collections against the appropriation from the Nuclear Waste Fund, not to exceed the amount appropriated for the repository. The Administration remains committed to working with the Congress to develop a satisfactory means of achieving that objective so that needed resources will be available to complete a repository expeditiously.

**Question:** **As I understand the proposal, the cost of electricity sold from federal dams could increase as much as 20% per year until the rates are at an undetermined market level. Also, while the Administration claims these rate increases will be gradual, OMB's revenue assumptions show a 41% increase in revenues from the PMA's. Isn't it hard to have a "gradual" rate increase with that type of target? What does the Administration consider a "market rate" for electricity?**

Answer: The Administration proposes to very gradually phase-in rate changes as contracts allow, and PMA revenues would rise just under 40 percent, but only over a ten-year period. For Southeastern, Southwestern and Western, which generally sell power in small amounts across wide areas of the country, the power is spread so thinly that increases to customers will generally have only small impacts on household bills. We estimate the increases for these three PMAs to be less than eight cents per month per household in 2006. For some areas where customers receive larger amounts of power from the PMAs, the Administration proposes to cap rate changes for these consumers. For Bonneville, the impact on consumers would be greater because Bonneville consumers receive proportionately more of their power from that agency. We estimate the impact on households served by Bonneville to be less than 50 cents per month in 2006. The Administration's estimates used for market rates are based on an average of spot market levels around the country at the end of 2004.

**Question:** **Has the Office of Management and Budget conducted any precise studies regarding the impact of raising electric rates in various electric markets?**

Answer: No, the Administration's estimates use data from the PMAs and Government Accountability Office studies regarding the number of customers and consumers in the PMA service territories and current PMA rates, and estimate the effect on rates from gradually increasing them to market levels.

**Question:** **Has OMB conducted any studies or can it point to any studies that would evaluate the impact on the Treasury if customers of the PMA stop buying higher priced, "market rate" power from the government?**

Answer: No, the Administration is not aware of any studies and has not conducted studies that evaluate the impact on Treasury of this type of situation. Under the proposal, PMAs would continue to first offer hydropower to their current customers. If these customers chose not to purchase the

power, we believe there would be a market for competitively priced PMA surplus power.

**Question: Will the additional funds generated by the PMAs be used for energy efficiency programs, low-income energy assistance or any similar programs?**

Answer: The Administration has assumed that the additional funds would be used by PMAs to more rapidly pay-down their existing debt.

**Question: Un-adjudicated Indian water rights claims are a source of great uncertainty regarding future water supplies for the west. As such, settling these claims is of particular importance to many western states. Of particular concern to my home state of New Mexico are the Aamodt (Rio Pojoaque Basin), Taos (Rio Grande Basin), and Navajo (San Juan Basin), Settlements. Resolving these claims will require the Administration's continued involvement in the settlement negotiations and a significant financial contribution by the federal government.**

1. **How do you plan to accommodate the upcoming New Mexico Indian water right settlements in the FY 2006 budget?**

2. **Do you feel that sufficient resources are available in this budget to ensure that the Administration and Indians are adequately represented in settlement negotiations?**

Answer: The President's Budget does not include funding for these or any other Indian water rights settlements that are currently being negotiated. Longstanding policy is to request funding for Indian water settlements in the year following enactment. Since these settlements are still in the negotiation phase, it is premature to include funding in the President's Budget.

The Administration believes that there are adequate resources to ensure Administration and Indian representation in settlement negotiations. The Administration is supportive of negotiated settlements. We have a responsibility to ensure that such settlements are fair to the tribe or tribes in question, and fair to the entire taxpaying public. They must reflect an accurate assessment of Federal liability, and ensure that any contribution by the Federal Government above our legal liability is based on a reasonable cost share by all the parties involved.

**Question from Senator Tim Johnson**
**Senate Budget Committee Hearing**
**OMB Director Josh Bolten**
**February 9, 2005**

**Question: It is my understanding the Crow Creek Indian Reservation in Fort Thompson, South Dakota is encountering difficulties in obtaining previously approved funding for replacing the Crow Creek High School gymnasium. This facility has been condemned and completing the project is a high priority. I would invite you to visit the Crow Creek High School to see firsthand the condition of this gymnasium. It has been several months since the funding for this gymnasium was initially approved, but delays continue. Can you please provide me with an update on the status of this project, including the cause of delay and your timetable for moving forward?**

Answer: Late last year, the Department of the Interior notified OMB that there was a safety issue at Crow Creek gymnasium and that the Department was proposing to reprogram funds within the School Construction appropriation account for the replacement of the gymnasium. During the normal review process conflicting engineering reports on the cost of replacing or repairing the gymnasium and the structural integrity of the current facility surfaced, but these have been resolved. OMB cleared the Department's reprogramming request for $2.6 million on April 15. Unfortunately, the school's dorm was damaged by fire on April 24. The Department is awaiting a structural engineering report to determine the extent of the damage before weighing its options to rehabilitate or temporarily replace the dorm. My staff is working with Interior to determine what is needed and how much it will cost. I expect that this process will be completed shortly.

**Question from Senator Jeff Sessions**
**Senate Budget Committee Hearing**
**OMB Director Josh Bolten**
**February 9, 2005**

Question: **I am a bit concerned by the portion of the President's Budget that outlines approximately $13 billion in savings in Medicaid spending over the next five years, $5.9 billion of which is expected to be saved via so called "payment reform."**

**As I have already expressed to HHS Secretary Leavitt, it is my sincere hope that the Administration will work closely with the States to ensure that any reforms to the Medicaid system are structured in such a way as to provide the least amount of disruption possible to the States.**

**Can you tell me if the Administration is planning to undertake this critical consultation prior to making any substantial changes to the system, or are such changes already set for implementation?**

Answer: The Administration is committed to continued discussions with governors, members of Congress and other stakeholders in the healthcare community on ways to modernize Medicaid. In fact, since the Budget was released, Secretary Leavitt has been discussing the Medicaid policies included in the Budget with a number of stakeholders. The Administration recognizes that Medicaid needs to be changed to keep pace with healthcare changes, and input from States is a critical component to developing our approach. There are several important principles assumed in Medicaid/SCHIP modernization: increased state flexibility, continued expansion of health insurance coverage to the uninsured, and long-term fiscal sustainability.

To achieve our goal of fiscal sustainability, the Budget includes a broad package of program integrity proposals designed to restore the credibility of the Federal/State matching system and address other payment concerns. These proposals reduce payment inefficiencies, promote personal responsibility for long term care expenses, and curb questionable financing practices that have been used by a number of States to avoid the legally determined State matching funds requirements. Even with these changes, Medicaid and SCHIP's future spending is expected to increase at a robust growth rate of more than 7 percent a year over the next 10 years.

We look forward to continued discussions with all the stakeholders on this important subject.

**Question from Senator Robert Byrd**
**Senate Budget Committee Hearing**
**OMB Director Josh Bolten**
**February 9, 2005**

**Question: Four years into the Bush Administration, I am disturbed to learn that only 18 agencies received clean audit opinions from the Office of Management and Budget, the same as the number as the prior year. I am particularly disturbed about the lack of progress at the Defense Department.**

**Please describe what resources are included in the President's request to bring the remaining agencies up to minimal standards of financial accounting.**

Answer: The President's fiscal year (FY) 2006 Budget provides agencies with the necessary resources to build on recent accomplishments of the President's Management Agenda (PMA), including improved financial performance.

This past year, federal agencies achieved a significant milestone in federal financial reporting with 22 of 24 agencies issuing Performance and Accountability Reports, including audited financial statements, within just 45 days after the end of the fiscal year. Prior to this year, agencies had typically taken up to five months to produce these same reports. Additionally, this past year the government-wide Financial Report was issued on December 15, compared to a March issuance in previous years. This accomplishment places the Federal Government financial reporting cycle on par with private sector reporting.

Despite the accelerated reporting time frame in FY 2004, a comparable number of major federal agencies received unqualified audit opinions on their financial statements as in the prior year. Of the 24 major federal agencies, 18 received unqualified audit opinions this past fiscal year. This is a noteworthy outcome given the increased rigor of the audit process, as well as the shorter amount of time to prepare audited financial statements in FY 2004. The accelerated schedule demanded good planning, timely reconciliations, and excellent execution.

We will continue to focus considerable attention on addressing the specific challenges facing the Department of Defense (DOD). In a department with over 300 sub-entities, many issues require complex long-term solutions and will take a sustained effort to resolve. In some cases, eliminating DOD

material weaknesses depends upon the implementation of new financial management systems, while other weaknesses require an incremental approach to transforming business processes. OMB will continue to assist the department and assist in addressing its specific weaknesses and challenges.

Through the PMA, we are holding agencies accountable to exceed current performance levels in the coming years, and the President's Budget provides the right level of resources to do so. For those agencies working to obtain an unqualified audit opinion and resolve other financial management deficiencies, the Budget ensures those agencies have the resources needed to continue implementation of corrective action and remediation plans. For example, the Budget supports financial system modernization efforts at the Department of Defense and the Department of Homeland Security that will facilitate the achievement of an unqualified opinion and other financial management improvements over the next several years.

**Question from Senator Robert Byrd**
**Senate Budget Committee Hearing**
**OMB Director Josh Bolten**
**February 9, 2005**

**Question: In order to finance more of the Transportation Security Administration budget from fees, the President proposes to increase the amount that an airline passenger pays per ticket, such as a $3 increase for a one-way ticket, from $2.50 to $5.50. According to your budget documents, the proposed increased fee would raise $1.5 billion next year.**

**One of the ways that the President accomplishes his restraint on spending is to assume that this expanded fee on our nation's air travelers will be enacted by the Appropriations Committee. However, increasing airline fees is under the jurisdiction of the Commerce and Finance Committees.**

**If we do not approve this proposed increase in fees, the Appropriations Committee will have to cut homeland security programs by $1.5 billion. Mr. Director, will you be calling Chairman Grassley and Chairman Stevens to urge them to ask the Appropriations Committee to approve this increased fee? If not, will you be asking Chairman Gregg to increase the allocation for the Appropriations Committee so that we do not have to cut homeland security funding by 1.5 billion?**

Answer: The Aviation and Transportation Security Act (ATSA), enacted in November 2001, authorized collection of these fees to pay for airline security costs, and the budget proposes that they be increased through the appropriations process.

Cost recovery of airport screening by the users of the screening system is an important goal. Aligning costs to fees will encourage system managers to pay more attention to efficiency needs in tandem with an effective security program. It will help airports and the Federal Government guide security screening investment decisions.

Reducing the support by general taxpayers of airport screening frees up homeland resources to be spent on needs that are more dispersed across the general population.

The President's Budget proposes to increase the aviation security passenger fee and substantially decrease fee collection estimates for the air carrier security fee. We propose to increase the passenger security fees by $3.00 on a typical one-way ticket. In addition, we assume that collections of the air carrier security fee levied on the airlines will be reduced to $350 million in 2006 from the Administration's assumption of $750 million in 2005. Under these changes, fee collections will rise from $2.6 billion for 2005, to $4.1 billion for 2006.

The FY 2004 Emergency Wartime Supplemental Appropriations Act suspended collection of the passenger security fee for four months. This is just one form of assistance provided to air carriers through appropriations legislation after September 11, 2001. Therefore, we believe jurisdiction over fee changes resides with the Appropriations Committees.

We encourage the Appropriations Committees to enact this important proposal to ensure adequate funding for the Department of Homeland Security. These fee changes will help recover nearly all of the $4.4 billion cost associated with Federal airport screening.

# THE PRESIDENT'S FISCAL YEAR 2006 BUDGET PROPOSAL

**THURSDAY, FEBRUARY 10, 2005**

U.S. SENATE,
COMMITTEE ON THE BUDGET,
*Washington, DC.*

The committee met, pursuant to notice, at 10:04 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Domenici, Allard, Enzi, Bunning, Alexander, Conrad, Sarbanes, Murray, Stabenow, and Corzine.

Staff present: Scott B. Gudes, Majority Staff Director; and Cheri Reidy.

Staff present: Mary Ann Naylor, Staff Director; and Steve Bailey.

## OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will convene the hearing. We appreciate the Secretary of the Treasury joining us today for a hearing on the President's budget, and he is going to give us some insight on tax policy within the budget, and I suspect tax policy outside the budget, and maybe a little insight on the value of the dollar and a few other issues that may be of interest to the committee.

My understanding is that the Senator from North Dakota has recovered from his recent slight illness, so we can also look forward to a wonderful presentation from the Senator, and we shall turn to his opening comments and then hear from the Secretary.

## OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. I thank the chairman. Mr. Chairman, I want to take just a moment and go back over some history I reviewed yesterday because I keep hearing things that I think are mistaken in terms of our economic history.

This is the chart I wanted to refer to that shows the relationship between our spending and our revenue since 1980, and the red line are the outlays, the green line is the revenues. The last time we had a huge gap, major budget deficits, was in the previous Bush administration. You can see outlays were running 22, 23 percent of gross domestic product. Revenues were varying between 17 and 19 percent, so we had that gap, and that gap is what created the deficit and increases in the debt.

Then in 1992 President Clinton was elected and a 5-year plan was passed that reduced outlays as a percentage of gross domestic product, as a share of our national income, and increased revenue. Some of our colleagues, in fact on the other side most of our col-

leagues said at the time this set of policies would crater the economy. It still rings in my ears, Senator Dole's final speech, that increasing taxes is going to crater the economy. We can go back down, check the record and see what in fact happened. It did not crater the economy. It set off the longest economic expansion in our Nation's history, the lowest unemployment in 30 years, the lowest inflation in 30 years, the strongest business investment expansion in our history.

How can that be? How can it be if you are reducing spending and raising taxes that the economy strengthens? One key reason is the other part of policy that affects the economy. That is monetary policy under the control of the Federal Reserve Board. Because the Congress and the President were being responsible on fiscal policy, the Federal Reserve was more accommodative on monetary policy, and that helped us grow. We even had 2 years where we were not only in balance, but we stopped using Social Security Trust Fund money for other purposes.

Then we ran into 2001, the recession, and of course the horrible attack, and the response was a plan of tax reductions and of course spending increases mostly for defense and homeland security. You can see the increase in spending, the reduction in revenue. About half of the reduction was tax cuts, about half of the reduction was because of economic slowdown and other factors.

Tax cuts, without question, were an important thing to do. Now, we had a great difference about how big the tax cut should be, who it should go to. We had great disagreements about that. We also had disagreements about how long lasting they should be in light of our long-term fiscal imbalances. But I want to make clear I proposed almost a trillion dollars of tax relief at the time to give a lift to the economy.

The problem that I see with the President's policy is there is no closing of this gap going forward. The spending line remains well above the revenue line under the President's projections, under CBO's projections, under the blue chip forecasters' projections, and I do not see any plan by the administration to close this gap. What strikes me as most dangerous about this is this gap which constitutes a deficit, which means the debt is growing because it is happening at the worst possible time. It is happening right before the baby boomers retire, and that is going to dramatically increase pressure on the Government.

So my own reading of this history is that we have to work on closing this gap, and we have to work on the spending side of the equation, you also have to work on the revenue side of the equation, and I do not see any proposal from the President, none, to deal with the revenue side of this equation.

I hope, Mr. Secretary, we can address this as we get into your remarks.

I thank the chair. I look forward to the testimony of the Secretary and we welcome you to the committee.

Secretary SNOW. Thank you.

Chairman GREGG. Thank you.

Senator DOMENICI. Mr. Chairman, could I just ask you a question?

Chairman GREGG. Certainly.

Senator DOMENICI. I am not going to ask him a question. That is your job. Is there any way to answer that or do you want to wait until my turn?

Chairman GREGG. Why do we not wait? I know the Senator from North Dakota tends to get juices fired on our side, but we did come to hear the Secretary of the Treasury. I am sure he will have some ideas on what the Senator from North Dakota said. He always manages to get us thinking, usually with enthusiasm.

[Laughter.]

Senator DOMENICI. Mr. Chairman, I am enthused. The reason I will not push you is that I just wanted to make sure that there was continuity. He presented one side, and there is a hole on the other side, and I did not want it to get away.

Chairman GREGG. We are going to let the Secretary talk about that, and I am sure in our questions, to the extent we feel that the Senator from North Dakota needs response, we will do that too.

Senator DOMENICI. Thank you.

Chairman GREGG. Mr. Secretary, thank you for coming, and thank you for your presentation today.

## STATEMENT OF HON. JOHN SNOW, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary SNOW. Thank you very much, Mr. Chairman, Senator Conrad, members of the Budget Committee. It is always a pleasure to be up here with the Senate Budget Committee, engage on a dialog with you on these critically important issues that come before the committee.

Let me say that this year I am pleased that the American economy is doing a lot better than it was a year ago at this time. We just got the news this morning that the U.S. jobless claims fell to a 4-year low. That is good news, 303,000, lowest in 4 years. Of course that is on top of the good news about the GDP coming in at 4.4 percent for the year; the 2.7 million additional jobs; productivity remaining strong; exports getting stronger—we need to close that gap—but exports are getting stronger; home ownership at an all time high; net worth of American families, household wealth at the highest in history; unemployment rates fallen down to 5.2 percent.

Mr. Chairman, we have made a lot of progress with the American economy, and I think it is undeniable that lower tax cuts that the Congress made available through the Jobs and Growth Bill lie at the center here of this good recovery we are enjoying. It is a recovery I would note that we are enjoying without inflation. We still continue to have a very benign inflation environment with mortgage rates low, with interest rates low, and of course interest rates tend to follow inflation. The low interest rates reflect I think the competition that is in the American economy and the high productivity that is in the American economy, conditions we want to make sure continue.

The President's budget also recognizes the need for fiscal discipline. It is a budget that calls for continuing focus on reducing the deficit, and calls for cutting the deficit in half over the budget window, taking it down to well below 2 percent. As Senator Conrad knows, as an expert on those numbers, the historic average of the

deficit is about 2.2, 2.3 percent of GDP. The plan we have is to bring it down to well below 2 percent, so low by historical averages.

I would agree with the Senator the real issue is those outyear numbers that are driven by unfunded mandates, by Medicare, Medicaid and Social Security, which is why the President has put Social Security front and center, proposed that we make it a legislative priority for this year, as he said in the State of the Union message. The system is unsustainable. The sooner we get to it, the sooner we address it, the easier the answers will be and the better the retirement outlook will be for younger people. Remember, we are reducing a huge overhang liability on the American economy, the 10.4 trillion dollars that the actuary of the Social Security system has identified as the unfunded obligation there, an unfunded obligation that grows according to the actuary at about 600 billion a year. So I agree with Senator Conrad. We need to be thinking about these longer-term deficits. They are driven by the unfunded mandates, by Social Security and by Medicaid and Medicare. Those are the really big issues for the future of our country. I have seen comments you have made, Mr. Chairman, on that subject as well, with which I want to be identified. We clearly need to find answers to those problems.

In the course of today's hearing I hope to offer some thoughts on that in response to your questions. We know that deficits matter. We know that the current deficit levels and the projected deficit levels are too high. There are really only two ways to deal with deficits. One is grow the revenues, the receipts of the U.S. Government. To do that we have to keep the economy growing and expanding. That is where a low tax environment I think is very helpful. We see now that revenues are coming up. So far this year they are up about 10 percent over last year year-to-date receipts. That is a direct reflection of the fact the economy is growing, expanding, jobs are being created, businesses are more profitable, because when that happens of course the Government gets a bigger take, they get more receipts. But I will agree with all of you that that alone is not enough. Growth will not get us out of this problem. We also have to focus on spending.

The President has sent up a disciplined budget to the Congress, one that constrains spending. Yes, the budget increases in the military area, and yes, it increases in homeland security. Those are national priorities that need to be funded. Outside of those areas you will see that the President's budget is very, very tight, many will say too tight. They said that last year. In fact, I recall last year testifying up here. The comments, not from the committee, but the comments in the media were: this budget is dead on arrival. Well, you did not adopt every line item of the President's budget, but Congress came out with a number that was right in line with the President's number, and I commend you for that. We do not expect every line item in this year's budget to be adopted either as sent up. You have your work to do in the Senate and in the House, but we would hope that you could stay in line with those overall numbers. That is what happened last year, and of course we came in with numbers last year that were well below the projections. I would hope that might even be, might be able to do that again this year.

But in any event, growing the economy, sustaining high rates of growth, and that is where low tax environment counts, and discipline on the spending side are the critical components of finding the answer, Senator Conrad, to the gap between those lines that you showed on that chart.

Mr. Chairman, I thank you very much for the opportunity to be here, and look forward to responding to your questions.

Chairman GREGG. Thank you, Mr. Secretary, and I appreciate the points you have made, and I think they are good and they should be reinforced. The main point of course is that this administration is addressing and has been willing to step forward on the long-term structural problems which we face as a society, which is the entitlement spending issue.

The President has, you may not agree with his positions or the colleagues on the other side may not agree with it, but he has stepped forward and put Social Security on the table for discussion. I regret that our colleagues across the aisle—and I am not speaking here about the Senator from North Dakota because he has been an exception—but that the leadership from across the aisle, especially the House leadership, has said there is no problem and that they are not going to address the Social Security issue because there is no problem.

The President has also been willing to step forward on the entitlement questions with a Medicaid proposal. I will be interested to see how many colleagues from the other side of the aisle decide that they are willing to address that huge health care question, which is how we pay for health care in the outyears and next year in the Medicaid area. It is a big question that needs to be addressed. The President has also taken on the sacred cow of agriculture subsidies. So the President has stepped forward on the entitlement side, which is critical. I am hopeful that we will also review Medicare at some point, but I can understand that the administration wants to allow its Medicare proposal to run a little bit here, at least startup before we get back to that issue.

On the discretionary side again the administration deserves to be congratulated because you have made the tough decisions. You have sent up a budget which is stringent, which gores everybody's ox, including the defense base, and we are hearing of course from defense contractors across the country about their concerns about defense spending. The budget is very responsible on the spending side of the ledger.

On the tax side of the ledger, I guess my questions would be, since you are the Secretary of Treasury, what would be the practical implications in this fledgling recovery, which is now getting to be fairly robust of increasing taxes? Was the fairly severe recession alot less severe because of the tax cuts?

Secretary SNOW. Absolutely, Senator, absolutely.

Chairman GREGG. What would be the effect of putting in place a major tax increase on small business in this country today, and especially small businesses which generally create jobs?

Secretary SNOW. Senator, I will not surprise you by my response. I think it would be a terrible mistake. The lower tax rates the small businesses are enjoying through the expensing provisions and through the lower marginal tax rates, because so many of

them pay their taxes through the ordinary income tax system as subpart S organizations. You would raise their tax rates significantly, and if you raise the tax rates of small businesses, they are going to be far less inclined to expand and to grow and to hire, and of course they do an awful lot of the hiring in the United States. Two out of three new jobs come from small businesses. I think it would be a terrible mistake.

Chairman GREGG. So when our colleagues from the other side of the aisle subscribe to the policies of Senator Kerry, who during his Presidential campaign suggested that the way you solve our budget problem is to significantly increase taxes on high-income Americans, as he described them, which are for the most part small businesses in those top brackets that are practicing as subchapter S corporations, and then of course he put in place another trillion dollars of spending on top of whatever he would have raised in revenue, so he would haveten a negative number anyway. But independent of the negative number that his proposals would have created in the deficit situation, the tax policy of dramatically increasing taxes on small businesses through a increase of marginal rates aimed at the top two quadrants of the marginal rates would have, in your opinion, a negative impact on economic growth and therefore cost jobs and reduce revenues probably in the long run?

Secretary SNOW. Yes, Senator, absolutely. I think it would be a wrongheaded decision. It would surely reduce small businesses' ability to invest in their businesses, and what creates jobs is small businesses investing in growing. Behind every job is some investment that somebody has undertaken. Roughly, it is $100,000 of investment behind every job. Small business will only invest when they see good returns, and lower tax rates mean higher returns for those investments.

Chairman GREGG. We will look forward to the other side putting forward their budget with that type of a tax increase, and then we can have that debate.

The one tax increase which clearly will occur if we do not take action in this 5-year window is the 15 percent dividend rate and the 15 percent capital gain rate will jump back up. I guess I would like to get your thoughts on that specifically in relation to an event which happened I guess about 3 weeks ago, where Microsoft paid out the largest dividend in the history of the country, I think something like $32 billion, which yesterday I believe Director Bolten said created more than a 0.1 percent jump in the GDP of the country, and meant that literally hundreds of thousands if not millions of Americans, who have investments, who work on the line at the UAW and have their UAW funds invested in Microsoft, or who work at a small restaurant and have their 401(k) invested in Microsoft, millions of Americans saw their income jump as a result of that dividend distribution, which was done as a proximate result of the reduction of the rate to 15 percent, which put Microsoft in a position where they felt that sort of dividend was appropriate.

I would be interested in knowing what your feeling is about first what happened as a result of the dividend cut to 15 percent, and then also the capital gain cut. How much have we seen revenues jump as a result of that cut? And then what will happen if we do

not extend those two tax cuts, which clearly the other side of the aisle appears to be resistant to?

Secretary SNOW. Senator, I think the evidence here is pretty clear even if it is hard to quantify fully. Both the reduction in the dividend rate and the reduction in the capital gains rates have affected behaviors. We see that in the fact that not only Microsoft but many more companies are now paying higher dividends than was the case before. As a former CEO who wrestled with the question of the amount of dividends to pay out and whether to raise dividends or reduce dividends, the question always was: is this a tax efficient way to reward shareholders? When shareholders had 39.6 percent marginal tax rates, paying them a dividend at that tax level always met resistance from the finance people in the company and from others, even stock analysts, saying that is a very tax inefficient way——

Chairman GREGG. If you could explain that for a second because I think it is important to the extent—I know everybody at this table understands it, but the fact that dividends when they are distributed have already been taxed once, and maybe you could explain that just so people understand it.

Secretary SNOW. Sure, Senator. The argument behind the President's initial proposal was that it is appropriate to tax income once, but once is enough. As an investor in a company you are looking for dividends. You are looking for appreciation too, but one form of income you would like is dividends. Before the company can pay you a dividend it has to pay a tax on its corporate income, and then the dividend is paid out of the after tax corporate income of the company. So by the time you get your dividend it has already been taxed at the corporate level.

The proposal that the President sent to the Congress last year you will recall was once is enough, let us not have that second tax on the dividend. If it has been taxed at the corporate level, then it should not be taxed at your level. While that did not carry the Congress, what did carry the Congress was I think a very thoughtful proposal to reduce the dividend rate to 15 percent. Many people were paying 25 percent, 30 percent, 35, 39 percent tax rates on their dividends. If you were paying 35 percent tax rate, personal tax rate, you got the dividend after the company had paid their 35 percent, you can see that ends up being a very high marginal tax rate, 35 at the company, 35 at the individual, 70 percent tax rate on the dividend, which is why I say in the old tax environment prior to the Jobs and Growth Bill, executives would, in response to shareholders' requests for more dividends, would often say: Mr. Shareholder or Mrs. Shareholder, that is a very tax inefficient way for us to distribute the earnings of this company to you.

Today, because of the action of the Congress, it is far less tax inefficient. That is the basic point.

And the same with capital gains. It should come as no surprise to anybody that the stock market did a nice pickup in 2003 subsequent to the time it became clear the dividend tax and the corporate gains reductions would be part of that legislation because the earnings of companies are now worth more in the marketplace since they are not taxed as highly. They are not discounted as much by taxes as once was the case. So the market puts a higher

multiple on the outlook for the company, and that takes the marketplace up. We saw I think in 2003 roughly a 30 percent increase in equity values, and last year about a 10 percent increase in equity values.

Senator I would assert that there is a direct relationship between the improvement in equity values and the market performance and the lower tax rates on corporate earnings through the dividend and capital gains that you made available.

Chairman GREGG. Thank you, Mr. Secretary.

Senator Conrad.

Senator CONRAD. Mr. Secretary, should we cut taxes another 25 percent in your judgment?

Secretary SNOW. I would not recommend that at this point.

Senator CONRAD. Why not?

Secretary SNOW. Because I think at current tax rates we are on a path, as your charts show, to bring the revenue stream back up to its traditional roughly 18 percent. It seems to me we should be able to fund this Government with a revenue stream of about 18 percent of GDP which is the historic average.

Senator CONRAD. Mr. Secretary, you mentioned in your opening statement that the deficit is going to get cut in half under the President's plan. Is that correct?

Secretary SNOW. Yes. The plan is to reduce it to about 1.7 percent of GDP by the end of the President's term, which would be more than cutting it in half.

Senator CONRAD. Of course that gets into a question of what the goal is, and is it in dollar terms or percentage GDP. But without getting into that, let me just tell you why I think that misses the mark. When I looked at 2009 here is what I see. The President is saying in his budget he is going to reduce the deficit to $233 billion. But he leaves out the money he is taking from Social Security itself. In that year alone he is going to take $242 billion of payroll tax money that was meant to strengthen Social Security and he is going to use it to pay for other things.

Back in the 1980's there was virtually no Social Security surplus to use in that way, so these historical comparisons have a big disconnect, and the big disconnect is in the 1980's a Social Security surplus in any 1 year was not in the billions, it was in the hundreds of millions. Now the Social Security payroll taxes were increased to prepare for the retirement of the baby boom generation, the Social Security surplus in that year is going to be $242 billion. Under the President's plan he is going to take all of it, not going to use it to strengthen Social Security, he is going to use it to pay for other things. CBO tells us the residual war cost in that year is going to be $55 billion, so that is not counted. Costs, according to CBO, to fix the alternative minimum tax, the old millionaire's tax that is rapidly becoming a middle class tax trap, is $54 billion in that year, and none of that is in the President's budget.

So what is going to get added to the debt that year? And it is interesting how the focus has been on deficits. There has been almost no focus on what is happening to the debt. The debt is going to increase that year, not by the $233 billion of deficit that the President is asserting, but the debt is going to increase by $584 billion. When we are running massive budget deficits and having

masses increases in the debt, and at the same time we have huge increases in our trade deficits, those twin deficits are requiring us to borrow staggering amounts of money and from all around the world.

Let me ask you this. In your judgment, does this increase in foreign borrowing, which by the way, just during this administration has increased 91 percent, increase in foreign borrowing has increased 91 percent, does that concern you at all? Here is the increase. We had four holdings of U.S. debt in January 2001, just about a trillion dollars. It has gone up to almost 2 trillion in just these few years.

Secretary SNOW. No, Senator. Those are the numbers. There is no arguing with them. What those numbers reflect, of course, is the fact that the American economy has been doing well relative to other economies, and as a result, we are importing more from those other economies, because we are developing more disposable income than they are relatively, and we recognize the issue there. I think the answer though is three things basically. One, we have to reduce our own dissavings through attacking the deficit problem you are putting on the table and the chairman is putting on the table and all of you are putting on the table, because our dissavings contribute to that problem. We need to improve national savings.

Second, it sure would be helpful if Europe and Japan and our trading partners would grow faster because if they would grow faster they would create more disposable income and be able to buy more from us. We are working with them on suggesting what they might be able to do, encouraging them to adopt growth policies.

The third piece of the answer I think is getting the Chinese to move toward—and this is a matter I have discussed with a number of you privately—the Chinese to move to greater flexibility in their currency, so that their currency reflects market values rather than some arbitrary determination on what the exchange rate would be. We are pushing all of those initiatives, Senator, but of course that is a matter we continue to monitor and monitor very closely, the current account deficit.

Chairman GREGG. Senator Domenici.

Senator DOMENICI. First, thank you, Mr. Chairman, and also I want to thank you for your analysis of the President's budget and the situation right now.

Just two observations before I ask a couple of questions. I do not have time to give the counter arguments to what the distinguished ranking minority member suggests has happened in the last 7 or 8 years or 10 years, including the Clinton administration's growth. Suffice it to say that there is an indication on the part of Democrats that this big era of growth that occurred that yielded the increase in tax revenues that he showed came because they increased taxes and from increasing the tax under the IRS. I think neither are true. I do not think very many people believe the tax increase caused the great growth. I think it was going to happen, and it had already started, and maybe it pushed it a little just because it affected the attitude of the investing community. Certainly tax increases do not account for what happened. Something else caused it to happen. In any event that is one observation.

Second, the big growth during that period that brought in all the revenue. I was there. That is how we balanced the budget, Senator, we had a big tax growth, unexpected revenue to the Treasury. That happened for two or three reasons. It happened because of capital gains that were occurring because of this huge stock market bubble. There is no question about that, and all the actions surrounding it brought these incredible revenue surges. Those revenue surges were not singly because of the growth, they were because of this very different set of economic facts regarding securities, regarding equity. I do not know if we will ever have that again so we are not going to get the benefit of that situation.

Second, my analysis is that looking at the long term, the biggest problem we have is that we are kidding ourselves if we think we can afford the cost of health care. Everything else pales as you look at the outyears, the future of America. When you look at the expected medical benefits that the American people perceive, they are almost so big when added to the private sector expenditures for health care, that most of our productivity will go to taking care of ourselves. I have been thinking that the time will come when you walk down the street, Senator Alexander, and you can say "Hello," and every third person you can say, "Thank you for taking care of my health," because that is how big the cost will be.

I am very concerned because our colleagues on the other side criticize the President while they know that their position is that we should not do Social Security and we should do Medicare. Maybe they ought to do Medicare. I have not seen any plan to reduce health care costs coming from the other side. Second, very simply, if they think we ought to increase taxes to take care of this, that is a simple proposition. They do not have to wait for us to do it. We are going to mark up a budget. Why do they not propose increasing taxes to show us that that will fix the budget? I would like to see the proposal and I would like to see how much it is. It would be very interesting to analyze its effect on America's growth.

Having said that, I want to ask you if you have done any studying about energy and energy prices and America's energy problems as it relates to our economic growth? I guess specifically, would you tell the committee what you project prices to be for major energy components during the next 5 years? Do you have that estimate as part of your Treasury analysis?

Secretary SNOW. Senator, we do not do those projections. To the extent they are done, they would be done by the Energy Department. The new Secretary there, Sam Bodman, comes from Treasury.

Senator DOMENICI. I understand.

Secretary SNOW. He had been the Deputy. But I defer to Secretary Bodman and the Energy Department on those projections.

I would say though that one of the striking things about the American economy, its flexibility and its dynamic qualities is how we have come through the energy shocks of the last year. If anybody had told you we would be living with $50 a year oil, you would not have forecasted 4.4 percent growth rates, and clearly those high energy prices have taken a toll on the growth rates, and yet we have plowed right through it. That is a testimony to the in-

herent strength of this economy, its flexibility, its adaptability, and I think again, for the low tax rates.

Senator DOMENICI. Mr. Secretary, we understand that, but that is almost stopped. That occurred because the changing nature of what caused productivity gains here. We used new equipment and the like which used less energy. I do not know if that is going to continue, but could you supply us, wherever you get it, with the 5- and 10-year projections on what you assume in the budget on energy. Will you answer in that what you assume energy, the condition of the energy market, what impact it will have on the American economy? Could that be an answer, would it have a drag, and if you can find out how much of a drag, we would like to know that.

Secretary SNOW. We do know that higher energy prices are a drag. They act like a tax.

Senator DOMENICI. Would you put that together with the other information?

Secretary SNOW. We will, absolutely.

Senator DOMENICI. Thank you, Mr. Chairman.

Secretary SNOW. Senator, if I could just make a comment on your earlier observations, because I think you helped frame the 1990's well. Most economists were surprised by the growth rates in the 1990's, and it was a nice time to be Treasury Secretary or in that case President of the United States, because there was this surge of revenues that had not been anticipated. It came from technology. It came from productivity increases associated with technology that drove equity markets and created a stream of revenue that could not have been anticipated. It is unrealistic to think that we are going to have a 21.6 percent revenue receipts level and sustain that.

So I would agree completely with you it was an unrealistic number, it was an unforeseen number, and it was an unsustainable number due entirely to the fact that we had the bubble. The bubble created a huge amount of capital gains and options returns, returns on options that raised the Federal income stream. That is not a sustainable situation.

Senator DOMENICI. Mr. Chairman, I understand your properly presenting the growth in tax receipts, as you have shown, that is correct. All I am saying is that if you look at the years we balanced the budget, that was not 10 percent growth in taxes like you described, it is much, much more, and I was trying to say that did not come from tax increases. It came from something phenomenal happening in the economy that you are not going to have while you are chairman, because there is a different ambience out there.

Chairman GREGG. Senator Stabenow.

Senator STABENOW. Thank you, Mr. Chairman, and Secretary Snow, welcome.

Mr. Chairman, I would hope that we might have an opportunity at the Budget Committee just to really talk about economics and what grows the economy. I think there is an honest and serious discussion that we can have about supply side economics versus supply and demand, and I think there is a very big—there is just a philosophical difference between one side of the aisle and others in terms of whether it is supply side, everything is focused on the top and it trickles down, or whether you need a balanced economy

with supply and demand. Personally, I think to bring us back to—and I do have a question for you, Secretary Snow—but to bring it back to where we were, 2001, the highest budget surplus in the history of the country, 4.6 trillion projected, now the highest budget deficit in the history of the country using predominantly a strategy of a supply side tax cut for the majority of that, understanding there were other costs. I think that pretty much basically starts with speaking for itself about where we are.

I had a gentleman, an investment banker, very wealthy, in the country, say to me yesterday he wanted to convey, to please convey to my colleagues that while he appreciated the huge tax cut he received, he knows he is going to pay for the deficit plus interest as well as the other investments in education and science that will be eliminated that we need to grow the economy, and he said thank you very much, please do not do that, let us have a more balanced strategic approach about how we do this.

When we talk about how we address jobs, I would just say a couple of things. One, a transportation bill like we passed on an overwhelming bipartisan basis a year ago in the Senate would create more jobs immediately than anything else we could do. 99,000 jobs are created for every one billion dollars spent. So I hope you will look at that. That is the demand side. Money in the pocket, good paying jobs for people who are customers of the businesses we all want to succeed.

Second, the No. 1 issue I am hearing from businesses is health care, which I do not know how in the world we address with these huge deficits we have. If my businesses had one request of us, whether it is the Big Three auto makers or whether it is small businesses, or seniors, or workers for that matter, it would be lower my health care cost.

And second, I am pleased to hear you talk about China and what is happening in terms of manipulating their currency because the second thing my businesses, particularly small and medium size businesses say to me, is level the playing field, enforce the rules on trade, and stop China from what they are doing.

Move to Social Security where my question is, and I would love for us to have a chance to really debate what I think are on the economy, serious and honest differences about how to approach economic growth.

Chairman GREGG. I think that is called when the budget hits the floor.

Senator STABENOW. Yes. Well, even in the committee though, I think that would be a good thing to do.

On Social Security, a couple of things. One, I feel compelled to go back. You were talking about unfunded mandates in passing Medicare, Medicaid. Just to remind all of us, Social Security is not an unfunded mandate. I pay in, you pay in, everybody pays in to an insurance plan that they expect to be there at retirement. The baby boomers have paid in more on purpose so there would be a surplus there. This is something people pay into and they own, it is not general fund dollars. And they expect it to be there, and that is our job, to make sure it is there, working together.

When we look at privatization, and most people today, many people would agree that privatized accounts do not do anything to

lengthen the trust fund. It is a philosophical difference but it does not do anything to meet the gap in 2042 or 2052. When we talk about how those would work, I think it is important to have a discussion even though we know all the details are not there. And I would ask you to followup on a comment that you made in response to a question in the House Ways and Means Committee earlier this week concerning what has been called the clawback or the privatization tax, as we would call it, where you indicated that that exists, that this clawback or payback exists. And you said if retirees earned less than 3 percent on their privatized account, they would do worse, but that is very unlikely.

So in fact this process is being talked about in terms of people not getting the full value of what has been put into the account, and in fact we are being told that what is being looked at is that a retiree would have to earn 3 percent plus inflation, which is about 5.7 percent, before they actually would see any benefit to the account. I would, in simple lay person's terms say, that is like giving my daughter, who is 25, $1000 for retirement; she moves forward and invests it. At retirement I say, "I want the $1,000 back plus 5.7 percent of your investment earnings. You get everything on top of that." Is that a good deal?

Secretary SNOW. Senator, let me address your question here. First of all, the Social Security system is not on a path where it can pay your daughter the benefits that it has promised.

Senator STABENOW. I would only interject, with all due respect, it is also not going bankrupt, and the differences we certainly on a bipartisan basis want to work to fix.

Secretary SNOW. I appreciate that and we should. But it is going bankrupt in the sense that a company goes bankrupt if it has obligations that it cannot cover. In that sense, which is the meaning of bankruptcy under Chapter 11 of the U.S. Code, or Chapter 7, it is going bankrupt because it cannot meet the future obligations. The idea of fixing it now is we can restructure it, we can modernize, we can put it on a sound financial footing at a lower cost than if we wait for what President Clinton called "this looming crisis" comes in on us.

Senator STABENOW. Secretary Snow, there is no disagreement with anybody on this. We have good faith discussions going on about how we make small changes now that have big impacts 40 or 50 years from now. It was certainly done in the 1980's when it was more imminent. I think the real question is, overwhelmingly we hear evidence that the privatized accounts are really about a philosophical change. It really does not—you are mixing the two together. It really has nothing to do with what do we do about the gap. It is about wanting to change to a privatized system. And my question to you would be, why is that a better deal for people, when (A) it puts an individual's dollars more at risk, requires them more to administer the accounts. They may not be better off. And essentially it begins to dismantle an insurance system. In a way it is kind of like if I put in a proposal say with my car insurance, instead of having the insurance company get the full premium I pay, I want to take two-thirds of it and put it in a private account. If I never have an auto accident, I am going to keep it. I do not think the insurance company would appreciate that.

Chairman GREGG. Senator, why do we not let the Secretary answer that question. Then I am going to have to move on.

Senator STABENOW. Thank you.

Secretary SNOW. Senator, what I can say I think without any fear of contradiction is that under a system of properly constructed personal accounts, the beneficiary will do better than they will under the current Social Security system. Your daughter will do better by being able to take some part of her payroll taxes and put it into these personal investment accounts, and use her working years to see those accounts grow. No less than the General Accounting Office rendered the judgment here that across cohorts, and I am just going to quote them, “Across cohorts,” meaning the various age groups retiring, “median monthly benefits of those choosing accounts are always higher despite the benefit offset than for those that do not make the choice.” And the gap, the difference, grows over time. Over any period of time these investments will do well and do better than the return you could get on the moneys going into Social Security.

I appreciate your comments. We really do want to work with you and your colleagues to find some answers here, and I appreciate your sentiments that something needs to be done.

Senator STABENOW. I would just say—and I know my time is up, Mr. Chairman—just that in looking at the numbers being used for people to be able to benefit from private accounts, it actually raises enough money that ironically the Social Security fund, where if we were growing at that rate, there would not even be a gap. So there are a number of questions we need to address. Thank you.

Chairman GREGG. I think it is also important to stress that the personal accounts the President is proposing are optional.

Secretary SNOW. Entirely optional.

Chairman GREGG. And voluntary.

Secretary SNOW. Entirely voluntary.

Chairman GREGG. Senator Alexander.

Senator ALEXANDER. Thank you, Mr. Chairman.

Mr. Secretary, thank you for coming this morning. I would like to step back a little bit and ask you about competitiveness, how we keep our jobs in the world marketplace and how this budget affects that because my sense is if there is a point person in the administration on competitiveness, it might be you. I would like to approach it this way. If I had to think of what the great challenges that face us are, one would be terrorism, one would be competitiveness and one might be preserving our common culture. When we talk about competitiveness, we have talked a lot about taxes here, and I am big for low taxes. Our State had the lowest taxes, and I voted for tax cuts. And I will vote for them again.

But if all we had done since World War II is cut taxes, we would not have a third of all the money in the world today for 5 or 6 percent of the people. We did a lot of other things. We created a telecommunications system, an interstate highway system, and perhaps the most important think we did was focus on brain power. We created the 50 greatest research universities, 20 Federal laboratories, this remarkable system where 60 percent of our students have grants and loans to help them go to college. And the President has a pretty good record on that, the President and the last

two Congresses I mean. Pell grants are up 50 percent. There has been a doubling of funding for research for NIH.

But my question is this: we have a real challenge here just as we did on terrorism, and on terrorism we looked around the Government and we saw that intelligence was spread all over the Government and not coordinated very well, so we created a Director of National Intelligence to make sure the President got advice. I am wondering if we should not be thinking about that for competitiveness, because we have $132 billion of research and development in this budget, but it is in agriculture, energy, defense, NASA, health and human services, commerce, transportation, interior, et cetera. It is as spread out as intelligence was. I wonder whose job it is to go to the President and says, “Hey, Mr. President, the Oak Ridge Laboratory researchers who went up to Canada for a conference could not get back for 6 months because of their visa,” or “States are not properly funding universities and the quality is going to go down,” or “We need to double the funding in physical sciences if we really want to create jobs.” I mean the National Academy of Sciences says that half of our new jobs since World War II came from science and technology.

So I am not suggesting we need to have a budget of more than 2.5 trillion, and I admire what the President has already done, and I like tax cuts. But I am wondering whether if terrorism is one big challenge and competitiveness is another, if you or someone in the administration ought not to be the point person for competitiveness and can keep our focus on this.

Just one last thought. The rest of the world is focused. You know that because you are in the rest of the world. China and India are keeping their best students home now. Germany and England are improving their universities because they see a big outsourcing of brains to the United States. While we talk about outsourcing of jobs, they are worried about outsourcing of brains.

So what can you tell me about your role as the point person for competitiveness and whether this administration in the next 4 years might organize itself in a different way, as we have with intelligence, to make sure we meet this challenge in the same way we have met terrorism?

Secretary SNOW. Senator, that is a very thoughtful question. I remember talking about a year ago to one of your successors, Secretary of Education, Rodney Paige, a very able person as you know, who was asking me about the economy. I was talking to him about the economy and the outlook and jobs coming back and so on. And all of a sudden it dawned on me that he really was going to have a lot more to do with the jobs of the future than I was. I said to him, “Rodney, Mr. Secretary, interesting you would ask me about that, but the fact is more hangs in the balance with respect to the quality of our education in the future than anything I am working on right now at Treasury. I am the spokesman for the economy, but you are driving the economy because the quality of the products that come out of our education system determine the jobs of the future and the productivity of the American economy for the future.”

Your point is very well taken. So is your point on the visas, a subject that I have talked to Secretary Powell about a number of times when he held that post, because clearly things like visa pol-

icy affect the performance of the American economy and our ability to sustain our high growth rates.

From the Treasury point of view let me say we are trying to work on things like tax policy and making the tax code simpler, fairer, more growth-oriented. It seems to me Government's role on the economy, which is really your question, how to keep America competitive, essentially has to do with putting in place the foundations or the framework so that the dynamic qualities of the American people in this great economic system of ours can be unleashed. But part of that is investing in the right things, technology, research, our great universities and so on. So let me think about that and come back to you for a more detailed question. But clearly, clearly we have to keep our eye on that question, what drives American competitiveness?

One thing it does is keeping the free enterprise system working, keeping our education system capable of turning out educated people because educated people are productive people, and productive people drive GDP, and they also, productive people lead to the innovations that allow us to have those higher standards of living in the future. So let me come back to you with a fuller answer to that excellent question.

Senator ALEXANDER. Thank you, Mr. Chairman.

Chairman GREGG. Senator Murray.

Senator MURRAY. Thank you, Mr. Chairman.

Thank you, Mr. Secretary, for being here today. I listened to your exchange with Senator Stabenow about her daughter and how she would be better off. I think you said you guaranteed she would be better off with the private personal account than she would today. I just wanted to go back through that because I was surprised to hear you say that. Perhaps she would be.

But according to Peter Orszag, who is a former economic adviser to the White House under the Clinton administration, walked us through this, and he said under current law a 25-year-old worker is scheduled to receive a monthly benefit of $1,708 in today's dollars. If there is absolutely no changes in the law, that that worker, that is what they would get today, but if we do nothing they will get $1,642, which is $66 less. So if we do not do anything, they will get $66 less than they are expected today.

But under the President's plan, the Commission Model 2, his calculations are that that person would receive only, $1,192, which is $516 less than what they are scheduled to get today. So there are disputes about that.

But let me be more specific because you are assuming that Senator Stabenow's daughter does really well, nothing wrong, nothing happens in her life. Well, if horrible happened and she became disabled in her 40's, she would not be better off because under today's current Social Security system she would get full benefits. If she only pays in to private accounts for 8, 10, 7, 20 years, would get much less, and so you cannot guarantee that she is going to be better off.

Another thing that could happen, which happens to many women, is that when she retires she buys the annuity, she lives to be 85. Under current law today Social Security has a COLA so that if you are on Social Security for 20 years you are not expected to

live at the same amount of income the you would get throughout that 20 years. You would be able, as hopefully we all can, to be able to have a COLA so that you will have an increased amount.

So I would say Senator Stabenow's daughter, if something happens unfortunately to her, would do worse, or if she does what many women do today and lives to be over 80, she would do worse. Or if you go by Peter Orszag's model, she would do worse. So I do not think there is any guarantee that anybody is going to do any better, and in fact I think the facts show that it is highly unlikely that she would.

So if you want to comment on that, you can.

Secretary SNOW. I would like to.

Senator MURRAY. And I have another question.

Secretary SNOW. Let me reply very quickly then.

Senator MURRAY. Well, my other question is, as I hear about this clawback provision I think very few people understand that the money that you take out to put into private accounts is not yours to keep, you pay back the Government, and I would like you to explain that clawback provisions so we all understand that.

Secretary SNOW. OK. I have not seen Professor Orszag's numbers, but I think the facts are pretty clear on this, that in 2042 there will be, when the system reaches the point where it can no longer pay the benefits, the money is not in the account, in the trust fund——

Senator MURRAY. And the President is saying private accounts will fix that?

Secretary SNOW. No. Let me just finish. Your daughter will receive, or a young person today who retires then will receive a big reduction in their Social Security benefits. That is the course we are on. The system is only capable of paying about 72 cents on the dollar of the promised benefits.

What I am saying is, with the personal accounts, the young person today who retires post-2042 will be able, with the personal accounts, to do better than they would otherwise be able to do.

Senator MURRAY. Should nothing bad happen to them.

Secretary SNOW. Pardon me?

Senator MURRAY. Should nothing bad happen to them.

Secretary SNOW. Now, on the disability issue, let me say the President's principles include sustaining the benefits of the disabled, so that anybody who is disabled, the President's proposal, his principles—he has four or five big principles. One is nobody over 55 is adversely affected. The system should be fixed permanently. Another one is the disabled provisions should be continued in a way that people get good protection for disability.

And on the dying, living a long time, which we hope everybody does, our proposal would be that people could take out an annuity and that annuity would then carry them through a long life.

Senator MURRAY. But I do not know of any annuities today that have a cost of living built in.

Secretary SNOW. Well, the——

Senator MURRAY. Social Security does.

Secretary SNOW. Yes, Social Security has a cost of living, but remember, you built up over your long working career an amount of

money which is much larger than anything Social Security could deliver to you.

Senator MURRAY. Except go back to the clawback provision, which means that you will not buildup that huge annuity.

Secretary SNOW. I think there is a misunderstanding on the clawback. That is a word that is ascribed to what we are proposing, but it is not what we are proposing. There simply is no clawback. Let me describe what we are proposing and then respond further. The idea here is that people are today contributing money to Social Security. They would be allowed to take some part of that, and put it into these personal accounts. The money withdrawn from Social Security would, as it goes into the personal accounts, would result in an equivalent, present value equivalent reduction in the long-term liabilities of Social Security. That is, as you take the money out, you are not contributing that money to it, your future claim on Social Security would be reduced by an equivalent amount. But that is all it calls for is reduction in future claims on Social Security equivalent to the amount of money that you are taking out, which seems only fair.

Chairman GREGG. And which makes a lot of sense if you are honest about the way you set up a personal account.

Senator Bunning?

Senator BUNNING. Thank you, Mr. Chairman. I would like a statement that I have prepared to be put into the record.

Chairman GREGG. Of course.

Senator BUNNING. Thank you.

[The prepared statement of Senator Bunning follows:]

**STATEMENT FOR SENATOR BUNNING**
SENATE COMMITTEE ON THE BUDGET
***The President's Fiscal Year 2006 Budget Proposal***
10 February 2005

THANK YOU, MR. CHAIRMAN.

WELCOME TO THE COMMITTEE TODAY SECRETARY SNOW. I LOOK FORWARD TO A MEANINGFUL DISCUSSION OF THE PROVISIONS CONTAINED IN THE PRESIDENT'S BUDGET PROPOSAL.

AS I HAVE REVIEWED THE MANY REVENUE PROPOSALS RELEASED THIS WEEK, I HAVE BEEN PLEASED TO SEE THE ATTENTION PAID BY THE ADMINISTRATION TO SO MANY IMPORTANT AREAS – MAKING HEALTH CARE MORE AFFORDABLE, SIMPLIFYING THE TAX LAWS, ENCOURAGING SAVINGS, AS WELL AS EXTENDING MANY EXPIRING PROVISIONS.

OF UTMOST IMPORTANCE, OF COURSE, IS THAT WE DO NOT ALLOW OUR ECONOMY TO FACE THE LARGEST TAX INCREASE IN HISTORY. I SUPPORT THE PRESIDENT'S CALL TO MAKE PERMANENT THE TAX CUTS THAT HAVE CONTRIBUTED TO THE 11 CONSECUTIVE QUARTERS OF ECONOMIC GROWTH THAT WE HAVE EXPERIENCED RECENTLY.

I WAS ALSO PLEASED TO SEE THAT, IN THIS YEAR IN WHICH WE PLAN TO FINALLY TAKE A SERIOUS LOOK AT THE NATION'S SOCIAL SECURITY SYSTEM, THE ADMINISTRATION IS ALSO TAKING A

SERIOUS LOOK AT PRIVATE RETIREMENT SAVINGS AND EMPLOYER-SUPPORTED RETIREMENT PLANS.

WITH REGARD TO EMPLOYER-PROVIDED PENSION PLANS, I HAVE LONG BEEN CONCERNED THAT OUR CURRENT FUNDING RULES, HOWEVER WELL-INTENTIONED, CAN HAVE THE EFFECT OF EXACERBATING THE LOWS OF THE BUSINESS CYCLE BY TIMING LARGE PENSION CONTRIBUTIONS FROM SPONSORING-COMPANIES JUST WHEN THOSE COMPANIES ARE FACING A DOWNTURN IN THEIR BUSINESS.

BY DOING SO, THE CURRENT RULES FAIL TO RECOGNIZE ECONOMIC REALITIES BY NOT ALLOWING EMPLOYERS TO MAKE ADDITIONAL PENSION CONTRIBUTIONS DURING GOOD ECONOMIC TIMES. THIS PREVENTS PLAN SPONSORS FROM POTENTIALLY BUILDING UP A CUSHION IN THE PLAN'S FUNDING WHICH MAY ALLOW MORE FLEXIBILITY IN TIMES WHEN THEIR BUSINESS IS DOWN WITHOUT COMPROMISING THE STABILITY OF PRIVATE PENSION PLANS.

I AM SO PLEASED THAT THE ADMINISTRATION IS PROPOSING SOME MECHANISMS TO ALLOW PLAN SPONSORS TO CONTRIBUTE ADDITIONAL FUNDS WHEN THEY HAVE THEM AVAILABLE AND I AM VERY INTERESTED IN HEARING SOME OF THE DETAILS OF THEIR PLAN.

THANK YOU.

Thank you, Mr. Chairman.

Welcome to the committee today Secretary Snow. I look forward to a meaningful discussion of the provisions contained in the President's budget proposal.

As I have reviewed the many revenue proposals released this week, I have been pleased to see the attention paid by the Administration to so many important areas—making health care more affordable, simplifying the tax laws, encouraging savings, as well as extending many expiring provisions.

Of utmost importance, of course, is that we do no allow our economy to face the largest tax increase in history. I support the President's call to make permanent the tax cuts that have contributed to the 11 consecutive quarters of economic growth that we have experienced recently.

I was also pleased to see that, in this year in which we plan to finally take a serious look at the Nation's Social Security System, the Administration is also taking a serious look at private retirement savings and employer-supported retirement plans.

Senator BUNNING. Secretary Snow, thank you for showing up. There are an awful lot of things I would like to ask you about, but I was pleased to see that the administration is finally looking at all aspects of retirement financing in addition to important Social Security changes. In particular, with regards to employer provided pension plans, I have long been concerned that our current funding rules, however well-intentioned, can have the effect of worsening the lows of the business cycle. Those rules can act to require large pension contributions from sponsoring companies just when those companies are facing a downturn in their business. I understand that the administration is proposing some changes to allow plan sponsors to contribute additional funds during good economic times when they have the money available. I have long thought this was a very sensible idea. I am hoping that you will comment on these proposed changes to the funding rules and how you think the changes will impact employer sponsored pension programs.

Secretary SNOW. Senator, thank you very much. Yes, this is a major initiative of the administration. We took the better part of the last couple years to think about the problems affecting the defined benefit pension plans, and the sponsors, and the Pension Guarantee Board, and have concluded that the system needs a major overhaul for some of the reasons you are talking about.

One of the biggest changes we are proposing is to allow employers, as you are suggesting there, to put moneys into those pension plans during the good years, put more money in, and to take the deduction that would go with it. The problem was always about the deduction and could they take the deduction. The rules would be changed to allow a deduction to accompany those higher levels of contributions in the good years. We think that will encourage employers in good times to put more money in, and thus help sustain the viability of those pension plans. There are a whole number of other rules as well that I think will help improve the financial status of the defined benefit plans, which will help both the employees, the employers, and ultimately the taxpayers.

Senator BUNNING. One of the rules must be that they cannot in the good years put it in and then the bad years take it out and use it for other purposes.

Secretary SNOW. You are absolutely right, absolutely right.

Senator BUNNING. OK. Congress has previously enacted many types of incentive programs, such as Renewal Communities and Empowerment Zones in order to jump start local economies in distressed areas. I am very interested in the Renewal Community Program as part of Eastern Kentucky participates in it. In fact, I included a provision in the Jobs bill last year addressing this program, an issue I worked with Chuck Schumer on. Can you address for me how the Opportunity Zones that are proposed in the President's budget exceed the capabilities of existing programs? What do you envision happening to participants in the existing programs, specifically Renewal Communities, and do you see them applying and being accepted as Opportunity Zones?

Secretary SNOW. Senator, as I understand these programs—and I am not an expert on them—the President's proposal is designed to be in addition to accompany the sort of program you are talking about, not in lieu of.

Senator BUNNING. In other words, an add on?

Secretary SNOW. Yes, yes. It is complementary to it. It does not withdraw it. It adds onto it. But I will have to——

Senator BUNNING. In other words, from what my quick—and it is quick when you get books about that thick—there is no cuts or no reduction in the funding for those other programs?

Secretary SNOW. I think the funding remains. The proposal would call for the establishment of a number of new zones, 28 urban, 12 rural, to be designated by the Commerce Department, who would select the zones through an application process designed, as you say, for distressed areas, focusing on what I think the words of art are, communities in transition. The idea is some communities have been hard hit by changes in the economy, and these economies in transition who had a steel plant or a textile mill or something——

Senator BUNNING. Under the current—I do not want to get into a confrontation—but under the current set up, Renewal Communities give tax breaks to companies to move there.

Secretary SNOW. Right.

Senator BUNNING. Are you saying that those things that you talked about would do likewise? In other words, the new zones you are talking about?

Secretary SNOW. Yes. There is a provision for income tax exclusion inside these—tax advantages inside the zones for enterprises inside the zones, but I will give you a full layout on it once I understand it better myself.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator Bunning.

Senator Sarbanes.

Senator SARBANES. Mr. Secretary, I know you all are looking for a crisis and you seem to think you have found it with the Social Security system because you project, and I think you use the earliest date of the estimates, that in 2042 the amount of money going out will be greater than the amount coming in, and at that point

it will be able to pay about 75 percent of the benefit levels. You all are using 2042; CBO says 2052. So that is about 45 years away.

I want to submit for your thoughtful consideration some other crises that seem to me to be looming right in front of us. One is the internal budget deficit crisis. The deficit now is, in nominal terms, the largest it has ever been, if I am not mistaken. Is that correct?

Secretary SNOW. In nominal but not real terms, yes.

Senator SARBANES. When you say real terms you are talking about percent of GDP?

Secretary SNOW. No. Even, I am talking about real dollars, inflation adjusted dollars.

Senator SARBANES. I noticed the Budget Director yesterday, when he talked about cutting the deficit in half, used percent of GDP. He did not refer to the dollar figure. Is that how the administration is now treating the budget deficit when they make these statements?

Secretary SNOW. I think the reason the Budget Director is using that formulation is probably the most authoritative way to look at it, the best way to look at it, because it is the way you would look at the mortgage on your house, it is relative to your income.

Senator SARBANES. Is that the formulation you use now? Has the administration in a sense shifted over, and is now using that formulation to talk about the budget deficit?

Secretary SNOW. Senator, I think we are talking about in both nominal terms, those dollars terms, and as a percent of GDP.

Senator SARBANES. Do you regard the budget deficit as a serious problem?

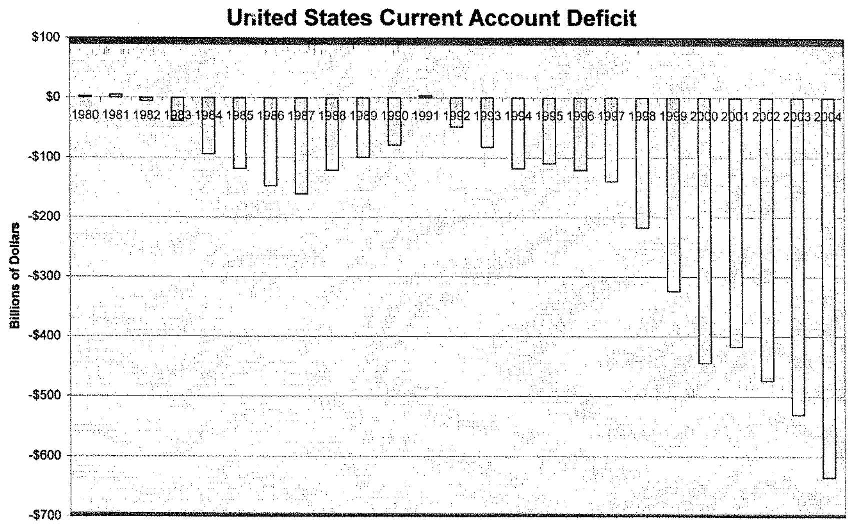
Secretary SNOW. Yes, I think the deficit is a serious problem and one that needs to be addressed.

Senator SARBANES. Is it serious enough to be categorized as a crisis?

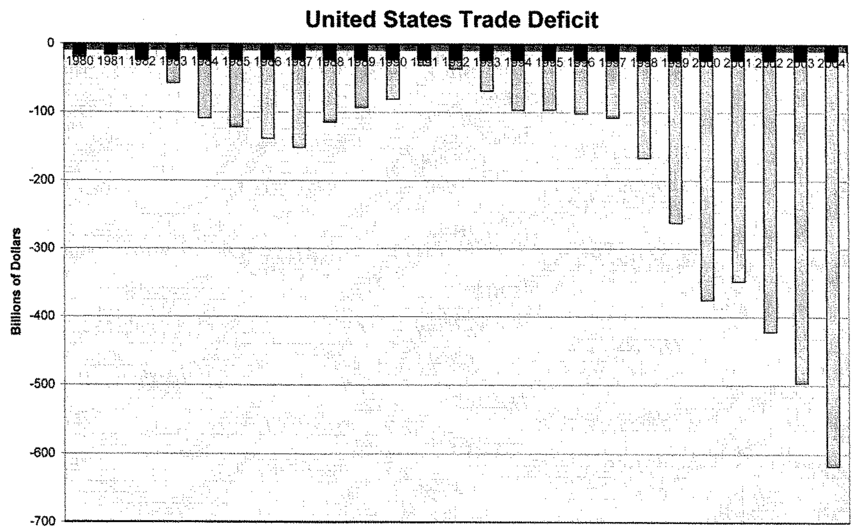
Secretary SNOW. No, not the deficit inside the window because we are bringing it down to a level that is low by historical standards, but long term, the deficit reflected in Senator Conrad's charts is certainly something that seems to me to be a looming crisis anyway, to use President Clinton's phraseology on it.

Senator SARBANES. That trend line takes off in 5 years.

Let me shift to the other crisis. I am concerned about these figures. This is the U.S. current account deficit. In the early 1980's we had a positive situation and then we started moving this way. But look at what has happened to our current account deficit over the last five or 6 years. It is incredible. We are now over $600 billion in the current account deficit, which of course reflects in large part what has happened with this rapidly deteriorating U.S. trade deficit. So we are now here. The figures are at record levels. Am I right in asserting that, that the figures on the trade deficit and the current account deficit are at record levels?




Source Bureau of Economic Analysis. 2004 estimated.




Source Bureau of Economic Analysis. 2004 estimated.

Secretary SNOW. Yes.

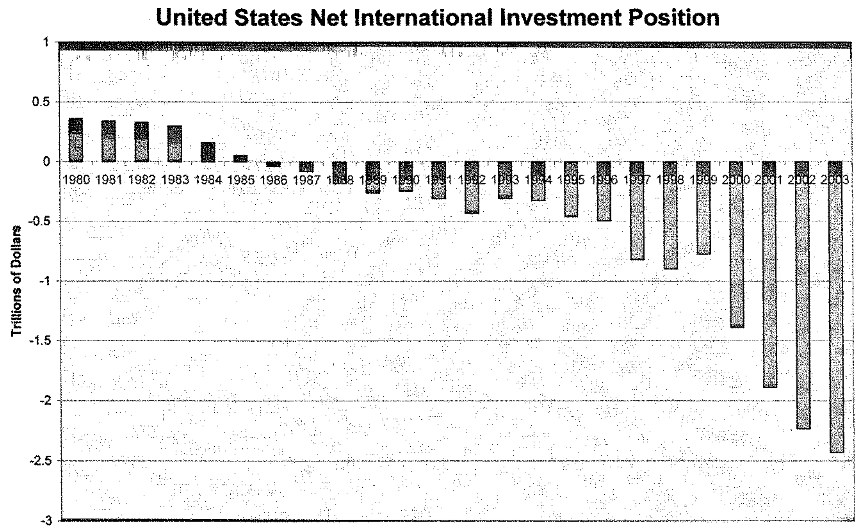
Senator SARBANES. Far beyond anything we have experienced in the past. Would that be a fair statement?

Secretary SNOW. Yes, Senator, as is our GDP.

Senator SARBANES. What am I to conclude from that?

Secretary SNOW. That there are a number of things that are growing.

Senator SARBANES. Including the deterioration in our net international investment position. Look at this chart. This is for 2003. It does not reflect 2004. 2004 is going to add another 600 billion to that. It is going to take us over $3 trillion into a negative net international investment position. This is claims that people abroad, or governments abroad, are holding against us, correct?




(Source: BEA, Survey of Current Business, valued at current cost)

Secretary SNOW. Certainly.

Senator SARBANES. In fact, have not the purchases of dollar assets in recent times been made primarily by the central banks in China and Japan?

Secretary SNOW. Yes, they have made substantial purchases of our debts.

Senator SARBANES. Do you think they are doing that in order to influence or impact the currency valuations and therefore to gain a trade advantage?

Secretary SNOW. No. I think they view the U.S. market as a good place to make investments.

Senator SARBANES. But not the private sector. There has been a shift from the private sector to the public sector, so these investment decisions now are being made by central bankers in China and Japan, correct?

Secretary SNOW. Certainly they have increased their holdings of U.S. treasuries.

Chairman GREGG. Senator, I do not want to interfere with your line of questioning, but you are a bit over your time.

Senator SARBANES. All right. I will close, Mr. Chairman.

Let me just make this point to you. I think they are manipulating the currency. You tell the Chinese to go to flexible exchange rates. All the experts tell us they cannot really do that right now without a serious banking crisis, and I cannot for the life of me understand why you do not shift your objective to getting them to reset the peg at least, which they could do without precipitating a banking crisis. You say flexible rates. All the experts say, "Well, the Chinese cannot do that. They will have a banking crisis." But they can repeg and not have a banking crisis, and it seems to me that at least ought to be one administration objective.

Chairman GREGG. Could you answer that question?

Senator SARBANES. Thank you, Mr. Chairman.

Secretary SNOW. Yes, Senator. We are in close and intense discussions with the Chinese. It is probably not best if I go into any detail about the nature of those discussions. I am encouraged by them even as I would like to see them move quicker. They are making progress on their financial institutions. They have indicated their commitment to move to greater flexibility, that is, a mean total flexibility, greater flexibility, which I think would accomplish the objective you are suggesting there.

Chairman GREGG. Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I would like to change the focus of some of the discussion here a little bit, and talk a little bit about your efforts to increase collections of those who are not supposedly paying their taxes. I have served in State legislature where proposals came in that said, "We are going to improve our enforcement," and it never quite measures up. I have been here in the Congress where they said, "Well, we are going to improve our enforcement," and never quite measures up.

My question on the figures that you are giving us, where they can collect $255.2 billion less than what the taxpayer owes, I would like to know how you are figuring this out. Sometimes I think what they give us is a gross figure. They do not figure in the cost of collection. Lots of times you have to take it to court or whatever, you

have to pay attorney fees, and take time and everything from your staff. You got to hire sometimes new employees and they do not get figured in. Can you shed a little bit of light on how you arrived at that figure?

Secretary SNOW. Senator, the figure you are talking about is this so-called tax gap figure?

Senator ALLARD. Yes. You are estimating that you collect, the IRS collects $255 billion less than taxpayers owe.

Secretary SNOW. Right. Senator, I do not put a lot of confidence in these tax cap numbers. We know there is a big number out there. We know that we can do better, but I must say that the tax cap numbers are not intellectually very satisfying to me, as I look at them.

Senator ALLARD. I am glad to hear you say that because I am having the same problems.

Secretary SNOW. I have talked about this with the IRS Commissioner, and there really is not, to be frank about it, any reliable estimate of the tax cap. We know it is big, we know it is sizable. It could be bigger, it could be smaller. I do not know. I am looking forward to getting the current study which is under way, updating this data, which I think is 17-, 18-years-old. We really need better data, and I know Senator Conrad has an interest in that, the chairman does, you do, and as soon as we get this updated study I want to give it to you and make sure that it is available. But right now I think we are in a state of ignorance, frankly.

Senator ALLARD. They are asking for more money to carry this out, and as I think as policymakers we need to make sure that there is some validity. I am glad to hear that you are going to try and update your figures, at least your methods of trying to do that.

Secretary SNOW. Right.

Senator ALLARD. On tax simplification, you know there is a level there where it just does not pay to fuss with the taxpayer because the cost of collection is more than what it I worth. I have had constituents come to me and say, "You know I had $45 I owed the IRS, and I paid it. Then they billed me again, and I paid it, then they billed me again and I paid it, because I did not figure it was worth messing around for 45 bucks." But in a way it is not fair to the taxpayer. Do they make any kind of assumptions that, well, you know, "If it is a low amount we will just keep hassling them until they finally break in. We do not care whether they are innocent or guilty." Would you respond to that?

Secretary SNOW. I think as with all laws—and laws need to be enforced—there is also a need to enforce them with a good deal of common sense, and one of our objectives for the IRS is that they enforce the law fairly and effectively, they go after real tax cheats, but they do so with a well-developed sense of good common sense as well, so that taxpayers are not harassed.

Senator ALLARD. It seems to me that any proposal we have on tax simplification, we might look at simplification of enforcement, and kind of bring up some common sense proposal into it.

I see I have some more time, so I want to talk to you a little bit about, or listen to you about what you are thinking about tax simplification. I would hope that does not include tax increases. I

would hope that it is truly simplification. I want to hear from you what you think is most practical in today's environment.

Secretary SNOW. This was a subject of conversation with two of your form colleagues, the two Senators, who will be Connie Mack, who is the chairman, and John Breaux, who is the Vice Chairman of this panel. They have been asked by the President to look at this issue of simplification and fairness and growth. When you get to simplification, Senator, as you know, somebody who has lived in this world of taxes, simplification means getting at the things that create complexity and the things that create complexity are credits, preferences and deductions. And Senator Mack and Senator Breaux, and Congressman Frenzel, who is also on this panel, as well as the other panel members, but those particularly, understand the give and take of simplification because one person's simplification is the removal of somebody else's equity. But they have pledged to come forward with their best efforts to give me and ultimately the President the best thinking they can come up with on what a sensible simplification would look like.

Beyond that I do not think I should try and foreshadow what they might do.

Senator ALLARD. Thank you for your comment. I see my time has expired.

Chairman GREGG. Thank you, Senator.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman.

Welcome, Mr. Secretary. First of all I want to identify with a number of the remarks that Senator Sarbanes made, but with regard to the negotiations on adjustment of the currency, those numbers are serious and at some point cumulatively create huge risks in our financial markets, and at least my experience would say if we do not start seeing some change in our position, trade position and current account position, there will be tough times at some point that tend to happen in short bursts as opposed to something that you can see over a period of time.

I actually want to ask some questions that are sort of definitional, and then I would like, if I have time, to get to will somebody be better off under Social Security reform as propositioned by the President?

First of all, I do not think companies go bankrupt—I was watching the hearing—when they have unfunded liabilities or health benefits. They have a period of time to adjusts. Is that not correct, Mr. Secretary?

Secretary SNOW. Yes, Senator, but I was not talking about pension plans. I was saying that Social Security is going bankrupt in the same sense that a private company goes bankrupt when it cannot meet its obligations. That is the sense of the word I am using.

Senator CORZINE. But it is in the same context as there are obligations that are contractually put in place for pensions and health benefits, and we have it with regard to our entitlement projects, and that by one estimate 2042, and the other 2052. I think it is very confusing if not misleading to say that Social Security is bankrupt, and by any comparison with any other standard. And then when you tie it to Chapter 7 and 11, there is no comparison since

we can meet all our financial obligations up until 2042, just from a standpoint of definitions.

Secretary SNOW. I understand, Senator, but it is in 2042, call it what you want, the system can no longer meet its heretofore promised obligations.

Senator CORZINE. Unless we do something.

Secretary SNOW. Right. We need to do something.

Senator CORZINE. I think we all agree we need to do something. So bankrupt I think is a term that probably does not fit this current situation.

On valuations of stock I heard a very interesting conversation about what drives stock markets. I do not know. Last time I took a finance course somebody told me discounted earnings flows over a long period of time are what people look at as what drives stock values as opposed to dividends and capital gains because it is a combination of all those things, and the earning power that people think. Have you seen the studies out that show that since we have cut the dividend rate that stocks that pay dividends have done more poorly than companies that have retained earnings? If you have not, I would be happy——

Secretary SNOW. No, I have not.

Senator CORZINE. I would be happy to just—this is under Davis Research, and I think actually there are a number of places. I would like to put in the record a Monday, January 31st Wall Street Journal article that would point out that companies that have been paying dividends, increased their dividends, have done less well than companies that have retained earnings. I think there are some—all of us are going to talk about what is correlated to the power of earnings, but I think we have had 10 percent growth in earnings in the last couple of years, and it probably has something to do with what marginal comeback we have had in the stock market.

[The article follows:]

The Wall Street Journal


Monday, January 31, 2005

Abreast of the Market

# Dividend Stocks Haven't Caught Investors' Fancy

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## Despite 2003 Tax Break in U.S., Bull Market Investing Still Favors Nonpayers Making the Big Gains

By E.S. Browning

FOR THE PAST two years, pundits have been forecasting a new era in dividend investing, but like many new eras, this one is off to an uncertain start. President Bush's move to cut dividend taxes to 15%, which took effect in 2003, was widely expected to provoke a flurry of dividend increases and investment in dividend-paying stocks. Half of that happened: Companies did announce a surge of dividend boosts, highlighted by the $32.62 billion special dividend -- $3 a share -- that Microsoft Corp. paid last year.

But the new passion for dividend stocks simply hasn't taken hold, at least not yet. Since the current bull market began in October 2002, investor treatment of dividend stocks has been about the same as it was in past bull markets.

That is, when the market has seemed strong, investors have tended to favor faster-growing stocks that don't pay dividends. Only during periods of market weakness have dividend stocks taken over leadership. Dividend stocks, in other words, continue to be treated as a refuge in times of trouble. They aren't emerging as leaders in times of strength.

The result: Since October 2002, stocks that don't pay dividends have produced significantly stronger returns than dividend-paying stocks.

"I have been very surprised" that dividend stocks haven't done better since the tax cut, says Terence McLaughlin, president and chief investment officer of New York money-management firm Lighthouse Growth Advisors, who likes dividend stocks. "Given how people got decimated after 2000, you would tend to think that people would want to come back and start owning more conservative stocks, which would pay them a dividend each year." Mr. McLaughlin says he thinks dividends will become more popular with investors with time, but that remains a question mark.

The nondividend stocks in the Standard & Poor's 500-stock index rose more than 63% since October 2002, according to Ned Davis Research. The dividend payers rose less than

52% -- and that includes their reinvested dividends, before taxes. After dividend taxes, the dividend-stock gains would have been less.

Some analysts say that it could take time for investors to get excited about dividends, and that the results will come. They point out that the dividend payers did much better last year than the nonpayers, rising more than 16% compared with less than 7% for the nonpayers. But the gains for dividend payers came when the market was soft, a time when investors feared the future, when dividend stocks historically have tended to be at their strongest.

When investors were more hopeful, dividend stocks fell behind. Starting in September, as confidence began to creep back, nonpayers again eclipsed dividend payers. Nonpayers rose 21% from the start of September through year's end, compared with a 13% gain (again, including dividends) for the dividend payers. It wasn't until the start of this year, as market confidence again plunged, that dividend payers again performed better. Through Thursday, they had fallen 3% since the year began, compared with a 7% decline for nonpayers. Of the 500 stocks in the S&P 500 index, 121 don't pay dividends.

While this failure of dividend stocks to become leaders may seem odd when you focus just on the tax cut, it makes some sense when you step back and consider the market as a whole. Investors always look for the biggest possible return, and at most times, they expect that to come from stock-price appreciation, not from dividends. Although dividends historically have made up more than 40% of stock returns, they make up far less today.

Even with all the dividend boosts of late, dividend payments represent less than 2% of the value of the stocks in the S&P 500. That 2% looks like great protection when investors think stocks are headed for trouble, but it doesn't catch their eyes when stock prices are rising.

"The dividend by itself isn't enough to make an investor buy," says Jack Ablin, chief investment officer at Harris Private Bank in Chicago. "It is just going to be the caboose on this whole decision."

Part of the problem, he says, is that the Bush tax cut applied to individuals, but not to pension funds or foundations, which represent a huge part of the investment community and tend to be more active investors than individuals. Such institutional investors never paid dividend taxes and are no more interested in dividends than they were before, he says. Last week, the Dow Jones Industrial Average finally did rise, after beginning the year with three consecutive weekly declines. That mild recovery helped nondividend stocks a little, but not much. Stocks appear ready to finish January with a monthly decline, which could bode ill for the rest of the year. The Dow industrials edged up 34.21 points on the week, to 10427.20. That included a decline on Friday of 40.20 points and left the industrials down 3.3% in 2005. The S&P 500 behaved similarly.

One thing some analysts forget is that, at about the same time dividend taxes were cut,

capital-gains taxes were cut, pushing the top capital-gains tax rate to 15%, says Tim Hayes, chief investment strategist at Ned Davis Research in Venice, Fla. That made it as attractive to take a capital gain as to receive a dividend -- more so for some people, since the capital gain may come years down the road, postponing the tax.

"If anything it may have increased the appeal of the stock market in general," Mr. Hayes says, rather than of dividend stocks in particular. At the same time, he adds, "there is a lagging effect between tax-law changes and dividend payouts." It is possible that dividend stocks will become more popular as investors slowly wake up to what is afoot and as companies raise dividends further.

Another thing that could help dividend stocks would be a prolonged period of weak stock performance, which is what many analysts fear may be in store.

In 2003, the Dow industrials rose 25%, making dividends seem puny. But last year, they rose only 3%, so a couple percentage points in dividends on top made a big difference. If stock gains continue to be moderate, investors could begin to chase dividends more actively. They could become even more interested in owning dividend stocks if the market were to continue the downward drift it has begun this year.

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Senator CORZINE. Another question I have, Mr. Secretary, over and over I hear about how small businesses have benefited from rate cuts, and I really think we ought to get the facts on the table because there is so much assertion that small businesses are the ones that are benefiting. According to the work that a number of analysts have done, and I think they have done this very specifically, only 436,000 of the tax filers with small business income, that is 1.3 percent of 32.8 million filers, actually were operating at the top tax rate. I suspect you will then translate that into who created jobs, is it those 1.3 or is it the 32.8 million filers. But do you believe that the top tax rate is driving the job creation in small business?

Secretary SNOW. Yes. I think the tax cuts overall, including the expensing, taken cumulatively and in the aggregate have certainly helped job creation. And small businesses, what do they do? They create 7 jobs out of 10 or something.

Senator CORZINE. 32.8 million of filers are not operating at the top tax rate, and actually the numbers are not so impressive even at the second rate. I think the question was framed in the context of if you were dealing with a top tax rate relative to choices we had to make on strategic investments in education or strategic investments in research and development. I see the red light.

Chairman GREGG. OK. You can continue that line of questioning.

Secretary SNOW. Senator, if you are asking me whether I think we should fail to make the tax cuts permanent, my answer is no. I think we should sustain the tax reductions because by doing so we avoid a tax increase, and tax increases I think would be not consistent with sustaining the sort of growth in the economy we want to see. Right now, as Senator Conrad and I discussed earlier, we are seeing the revenue line of the U.S. Government, the top line of the U.S. Government with the tax increases rise and improve, and revenues this year so far are up about 10 percent for the Federal Government, and I think the lower tax rates are helping get the economy stronger with more jobs, more profits, which is leading to higher tax revenues for the Government.

Senator CORZINE. Maybe Microsoft had something to do with that dividend and the repatriation of profits from overseas, but it is worth an analysis.

I do have the request that I would love to see the Treasury put together numbers so that we could once and for all analyze whether the top tax rate is really applying to small business. And I know it has to include S-corps and all the other elements of it, but we hear that argument so much that it would be worthwhile having some definitive objective research on that made available.

Thank you.

Chairman GREGG. Thank you, Senator. Are there Senators who—did you have some second questions?

Senator DOMENICI. Yes.

Chairman GREGG. Why do you not go?

Senator DOMENICI. After we finish with me we are done?

Chairman GREGG. After we finish with you, we are going back to Senator Conrad and then if Senator Corzine wants to go again, we will do it.

Senator DOMENICI. Mr. Secretary, I just want to spend my time on Social Security. If you do not mind, can we talk together about it? We are using this data, 2042, and some people use the word bankrupt and others say it is not bankrupt. What happens in 2042 if we do nothing, and assuming some reasonable path of growth and all the other things we say?

Secretary SNOW. Senator, in 2042, if nothing is done in the interim, according to the actuary of the Social Security system, the trust fund will have insufficient revenues to pay out the prior level of benefits and will only be able to pay out benefits at about 72 percent of the former level, 72 cents on the dollar of the former benefits that had been paid.

Senator DOMENICI. So are we saying that if we do nothing, at that point in time everybody that is getting a check from Social Security will get reduced by 28 percent, and those who are waiting in line and not yet there, their expectation is rather bleak as to what their benefit is going to look like. Is that correct?

Secretary SNOW. Yes, they will take a big haircut on their benefits. That is right.

Senator DOMENICI. Now, when we use the 2018 to 2020 number, what are we talking about?

Secretary SNOW. Senator, the 2018 number, which is a very important year, is the first year that the withdrawals from Social Security, the payments out are greater than the payments in, the inflow. The outflow exceeds the inflow for the first time, and that will continue in every year thereafter.

Senator DOMENICI. OK. Now, Mr. Secretary, whatever you call it—bankrupt or the 2018 phenomenon—those are dates when Social Security, the program, there are signals of serious trouble, and then in 2042 there is big trouble because the checks are going to be dramatically reduced. Is that correct?

Secretary SNOW. Precisely. That is exactly what happens.

Senator DOMENICI. Now, the question is: Should we try to fix it later or sooner? My question to you is: Will it be easier to fix it now for our seniors, or will it be easier to fix it later?

Secretary SNOW. Senator, I can quantify that. It is much easier to fix it now. If we look at just the arithmetic, fixing it now through—say you wanted to fix it through a benefit cut, or you wanted to fix it through a tax increase—I am not recommending either, but I am just giving you the arithmetic. Today it could be fixed with about a 3.5-percent change in either. If we wait out in the future there, 2042, it is double that. It takes a 6.5- or 6.6-percent change to fix it. So you would be adding a 6.5-percent tax in 2042 to fix it to the 6.4 that you pay today—the 6.2 that you pay today. So you would be doubling the tax on the individual in 2042.

Senator DOMENICI. Let's just stay with that. What we are saying is if we just wait around and the crisis occurs, the people paying in—that is our grandchildren and young workers—they will have to pay almost twice what we are taking out of their payroll checks now to make this fund solvent.

Secretary SNOW. That is right, Senator.

Senator DOMENICI. So out there in America, for the young people, they can expect that they will not get their checks in toto, they will

be dramatically reduced, or they will take out of their paychecks twice what is being taken out now.

Secretary SNOW. That is right. They will have a huge tax increase.

Senator DOMENICI. I assume that is what the young people understand. I have seen young people who get a payroll check for the first time, and they say—they come home, two of my daughters, and say, "I thought I was in a low bracket. Look at how much they took out of my check." Well, it was the Social Security they were looking at. So that would be double what it is now, more or less.

Secretary SNOW. That is right, Senator. That is right.

Senator DOMENICI. Now, when we speak of repairing this system sooner rather than later, we are talking about in the case of the President's notional fix, notional repair, taking a piece of that money that is going to into the fund and investing it. And let's just look at that by itself, just that. You are investing it. Can you give us, in some way that we would understand, how much more is generated that goes into these personal accounts than if the money was invested as it is now in Social Security, compounded? Do you have a chart showing that or can you give us that?

Secretary SNOW. Yes, Senator, I will be happy to supply that. I can give it to you sort of rough and ready. If you are an average wage earner born in 1985, 20 years old, you would be retiring in 2050. If the system could pay out to you in 2050 what it promises, you would get $20,000. You would get almost $21,000. Unfortunately, the system can only afford to pay you $15,000. So that is that haircut I talked about.

If that individual now took advantage, that 20-year-old took advantage of the opportunity to withdraw some of their money and put it into these personal accounts, by our estimate they would—and this is earning just the average sort of market return of a mixture of debt and equity—they would end up with $17,000. So rather than the $15,000 that the system could pay, they would get $17,000. And that comparison gets better with every cohort going out because the system becomes less and less and less capable of paying benefits over time.

Chairman GREGG. Thank you, Senator.

Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Mr. Secretary, what are the estimates of economic growth that underlie the forecast that Social Security will not be able to meet its payments in 2042, according to the Social Security Administration, or 2052, according to CBO?

Secretary SNOW. Senator, I think the growth rates for GDP are something like 1.8, 1.9, something on that order.

Senator CONRAD. Yes, that is correct.

Secretary SNOW. Going forward.

Senator CONRAD. And what has been the economic growth rate over the last 75 years?

Secretary SNOW. It has been considerably higher than that because of the combination of productivity and population growth for the last 50 years. Population growth, demographic growth, has been much higher than the actuary sees for the next 40 years.

Senator CONRAD. Let me just say that Senator Domenici has commented in the past on productivity growth. Something is happening with productivity growth that we do not fully understand. We have had much higher rates of productivity growth than were anticipated by anyone, I think it is fair to say.

So one of the concerns I have about these projections in Social Security, first of all, they are 75 years. Second of all, they are really very pessimistic, 1.8-percent economic growth when we have had 3.4-percent economic growth in the previous 75 years. That is the first, I think, important fact to know.

Second, Senator Domenici had suggested that some of us do not think you need to do Social Security, do Medicare first. I want to make clear my own position is I think we need to do both. I think we need to do both. The fact is the head of the General Accounting Office told us the shortfall in Medicare is 8 times the shortfall in Social Security. So I urge the President to deal with Social Security and Medicare.

Senator Domenici said, well, he has not heard any proposals on Medicare. I will give you four quick proposals on Medicare. No. 1, 5 percent of the people use 50 percent of the money. We ought to focus like a laser on that 5 percent by better coordinating their care. In the pilot projects we have run to do that, we have saved dramatically in expenses, we have reduced hospitalization substantially, and we haveten better health care outcomes. So that would be No. 1.

No. 2, I think we ought to go back and look at the $10 billion slush fund we provided the Secretary of HHS to sweeten the pot for private accounts.

Third, I think we ought to look at the $40 billion we are giving private accounts over and above what traditional Medicare pays.

Fourth, I think we ought to look at reimportation from Canada.

Fifth, I think we ought to allow Medicare to negotiate lower drug prices. They are specifically precluded under the law from doing that.

So if we want suggestions, I think it is—I welcome the Senator's call for that. I think that is exactly what we need. I think we need to have everybody come with their best ideas, and we need to work on Social Security and Medicare, and I think tax reform, too. There was a question about the tax gap. The tax gap that your IRS agency has developed, 2001, $300 billion tax gap, the difference between what is owed and what is paid. Unfortunately, that is based on a modeling of economic behavior that is 17 or 18 years old, updated for 2001 figures. I think it badly understates the tax gaps. As a former tax administrator and the former chairman of the Multi-State Tax Commission, I have spent a good deal of time analyzing those numbers—with your people, by the way, Mr. Secretary—and I believe we will find in the new analysis that the tax gap is really much larger.

And so when I say we need to bring revenue to the table—and I know some of my colleagues immediately assume that is a tax increase—that is not necessarily the case, is it?

Secretary SNOW. No. I agree.

Senator CONRAD. If we could find a way to effectively capture part of that tax gap—and, by the way, that is why I think tax re-

form has got to be on the table here as well, because I do not think you are going to capture as much as we need to just by jiggering with the current system. The current system is a horse-and-buggy system that was devised largely in the 1930's, and we have to go back and do a much better job of improving the efficiency of the system.

Secretary SNOW. Senator, I think your former colleagues who are chairing this panel, the tax panel, share those sentiments entirely.

Senator CONRAD. Let me just conclude with—let me show that. This is where I have a profound disagreement on where you say this is all headed. This is your assertion of what is going to happen to the deficit in the coming 5 years, but you get there by leaving out a lot of things. It is sort of like a family having a budget and they say, gee, things are really going well, if we just leave out our mortgage payment and our car payment. But that is not the way it works with a family, and that is not the way it works with the U.S. Government. And you all have just left out a lot of things, like the war costs past September 30th of this year, like the need to fix the alternative minimum tax, a whole series of things that have just been left out.

When we put those things back in, here is what we see as the pattern, somewhat of an improvement, but then when we get past the 5-year budget window and the full cost of the President's tax cuts come in, the situation further deteriorates. And, you know, in a way this does not even capture what is happening.

So I would just say to my colleagues, I do not think I see anything that is very serious about dealing with this deficit. And for those who now say deficits do not matter, I think that is a preposterous position. Do you believe deficits matter, Secretary Snow?

Secretary SNOW. Absolutely, Senator. I think you and I have talked about that. They do matter. They make a big difference. Financial markets are watching this. We have to make sure that black line never materializes, and there would be serious consequences to pay if it did. So the administration knows, the President knows that these deficits are too large, that they matter, and we have to reduce them.

Could I just offer one thought, though, on your observations on GDP growth and productivity growth and Social Security? Social Security is really not driven by GDP growth, I mean the problem there, because higher GDP growth translates into higher wages, and given the benefit formula, that translates into higher obligations, so you cannot grow your way of out the Social Security deficit problem given the formula or given the current rules of the road.

Senator CONRAD. Mr. Secretary, you and I would agree on that. That is why I do believe Social Security has got to be addressed as well as Medicare, as well as tax reform. It would help—I mean, obviously if you have higher rates of economic growth, that helps all of our challenges of meeting our long-term budget obligations. And it is really those long-term budget obligations that are our central problem. I think you and I would agree on that.

Secretary SNOW. Absolutely.

Senator CONRAD. The real problem we are going to have, as the chairman has said, is how are you going to redeem those bonds. The Social Security Administration holds these bonds. They are

backed by the full faith and credit of the United States. They are going to get paid. But how are they going to get paid? That really is the challenge before us.

Secretary SNOW. Exactly.

Senator CONRAD. Thank you.

Chairman GREGG. Thank you.

Do you have any additional questions, Senator Corzine?

Senator CORZINE. I will be very quick. Mr. Secretary, does the privatization formulation address that 30-percent gap? Does it provide for solvency 2042 and out?

Secretary SNOW. Senator, we call them personal accounts rather than private accounts because we really do not view what we are doing as privatizing Social Security. But the personal accounts, while not alone addressing the gap, are, I think, part of an overall solution. They are an integral——

Senator CORZINE. Just dealing with the solvency issue, do personal accounts accommodate the language? Do they deal with the solvency issue?

Secretary SNOW. The underlying purpose, as I understand it, of Social Security is the retirement security of the individuals who are in the system. And if that is the overall objective, which I think it has to be, then the personal accounts play a critical role in achieving the underlying objectives of Social Security.

Senator CORZINE. Financially?

Secretary SNOW. But alone they do not deal with the financial problem. They have to do it in concert with other things.

Senator CORZINE. What is the real rate of return and then the nominal rate of return that you use to get to this $3,000 discount from the benefits that were talked about?

Secretary SNOW. I think it is a 3-percent real rate of return.

Senator CORZINE. A 3-percent real rate of return, if I have done my numbers right, will give you a bigger discount than $17,000 for your individual. But I would like to know specifically what it is, the rate of return that is built into——

Secretary SNOW. I am sorry.

Senator CORZINE. Both the break-even——

Secretary SNOW. The 3-percent is break-even; 4.5, I think, or 4.6 gives you the $17,000 I talked about. Three is the break-even.

Senator CORZINE. That is the 7.5 percent that you are using that is the average nominal yield over the extended period of time.

Secretary SNOW. Yes.

Senator CORZINE. To get back to the $20,000 mark, what would be the rate of return, the nominal rate of return that would be required?

Secretary SNOW. I think you need an equity rate of return, 6.7 or something.

Senator CORZINE. Above the base.

Secretary SNOW. Yes, real.

Senator CORZINE. Something in the 11-percent——

Secretary SNOW. Nominal, yes.

Senator CORZINE. Right. I think these kinds of questions—and, you know, I wish I could guarantee myself I was going to make 11-percent nominal rates of return over a historic period of time com-

pounded. That is presuming that you would make that in this 50-year timeframe that you are talking about.

Secretary SNOW. Yes. The——

Senator CORZINE. Regardless of pattern or when you retire or——

Secretary SNOW. It is the average, yes, over the period.

Senator CORZINE. The question that I think is fair to ask is: Looking at different points in history, what is the probability of those kinds of returns, whether it is the 7.5 or 11, applying to any cohort set of retirees? And any way you look at it, there is some risk factor that you have to assign to whether that is at all probable. You know, I think we all talk in certain terms. Those of us who are not particularly thrilled with personal accounts would say we are not—we are probably focusing too much on one element of risk. I think there is an ignoring of risk with regard to those kinds of returns actually coming to pass.

Secretary SNOW. Senator, the returns we are citing are the 40-year averages for blended—you know this better than I do, but blended stocks and equities and a full equity and various ratios. But I think the 4.5, 4.6, with a fund over 50 years or 40 years of bonds at 40 percent and equities at 60 percent produces that 4.6.

Senator CORZINE. If you go back and look at any given starting point, though, you get different patterns for each cohort that started work and then retired. It is just—I think too often we talk in certainties, and, frankly, I was surprised to hear you say, you know, you are going to come up $3,000 short relative to what you would get under Social Security if we did some of that tinkering around that Senator Domenici was talking with you about, you know, got another Greenspanian commission to sit down behind closed doors and come out and give us the ability to say, well, let's tinker with this variable or that variable and get this resolved, which I think most people——

Secretary SNOW. I do not think tinkering—the problem, though, is that tinkering will not solve it. As I say, if today the system is out of kilter by 3.5 percent on benefits or taxes, it is out by 6.5 percent in 2042. Those are the actuary's numbers. That is a doubling of the taxes on individuals.

Senator CORZINE. If you wait—and I think all of us agree, from whatever perspective, that doing something now is a heck of a lot easier to solve this problem. Even your own example does that.

Secretary SNOW. Right. Senator, I think there is more to agree on here than disagree on. I think there is a sense that there is a real problem, that the sooner you act, the better. I think President Clinton—I like his formulation of the issue. It is "a looming crisis." He said that in 1998. So it is coming in a little closer on us. If it was looming then, it is looming-plus right now.

Senator CORZINE. Thank you, Mr. Secretary.

Chairman GREGG. I just do have to comment on this because I spent so much time on this issue and was there with President Clinton when he called this "a looming crisis," and I had a bipartisan bill which did address this issue, and we did adjust benefits. We adjusted tax rates, and we created personal accounts. But the point, of course, here—and I think you, Mr. Secretary, put it in numerical terms, but I think it is important to put it in personal

terms, which is that if you were to guarantee the benefit of Social Security as it exists today to a person who retires in the year 2042, that benefit, the $20,000 you are talking about in today's dollars, would cost the working American, our children and our grandchildren, a doubling of their tax burden, which would mean that their lifestyle would be radically reduced. Their ability to send kids to college, their ability to buy a house, their ability to buy a car, their ability to live a good lifestyle would be radically reduced by the need to support my generation which would be retired. And that is what this is about.

Secretary SNOW. That is right.

Chairman GREGG. We as a generation, because we are the baby-boom generation which is so disproportionately larger than every other generation in the history of this country, have an obligation to fix the Social Security system before we hit it and put that burden on our children where they live a lower quality of life because they have to support us. And that is what this administration stepped up to the table on. I regret that members on the other side, especially in the House, are saying there is no problem, because there is a problem. Whether you call it "looming," whether you call it "crisis," whether you call it "bankruptcy," our children are going to face the largest intergenerational tax increase since the drug plan, which was an inexcusable act, if we do not fix this situation for them.

And so I at least congratulate the administration for stepping up to the issue. I hope we can reach consensus on it, and one legitimate way to do it is to use personal accounts to assure that at least our children have some asset which they own, which they will actually retire with, or which, should they unfortunately get hit by a truck before they retire, can pass to their children.

So I congratulate you on creativity. Thank you for your time. You have been very generous with it.

Secretary SNOW. Thank you very much, Mr. Chairman.

Chairman GREGG. We appreciate it.

[The prepared statement of Secretary Snow follows:]

**Secretary John W. Snow**
**Opening Statement**
**Hearing Regarding President's FY '06 budget Request**
**Senate Budget Committee**
**February 10, 2005**

Good afternoon and thank you Chairman Gregg and Ranking Member Conrad for having me here today to discuss the President's budget. I think you'll find that it exhibits a dedication to fiscal discipline, transparency, and economic growth.

By focusing on priorities and looking for savings in every agency, across the board, the President's administration has come up with a budget that we believe is fair while also holding the government accountable. As the President announced in his State of the Union Address last week, this budget adheres to the principle of "Taxpayer dollars must be spent wisely, or not at all."

It holds the growth of discretionary spending to just 2.1 percent, below the expected rate of inflation. Non-discretionary spending in this budget falls by nearly one percent, the tightest such restraint proposed since the Reagan administration.

This administration appreciates that cutting taxes and exercising fiscal discipline must go hand in hand. We appreciate that this is the people's money with which we are dealing, and that we work for the taxpayers.

That is why we are committed to making the President's pro-growth tax cuts permanent and building on our strengthened economic fundamentals as we submit to you a budget that will increase the efficacy of our government programs without over-spending the taxpayers' money.

Over the weekend, the finance ministers of the G7 met – the U.S. was represented by Treasury Undersecretary for International Affairs John Taylor – and they discussed the importance of promoting and achieving economic growth in our countries, as well as keeping our respective financial houses in order. These two issues are inextricably linked.

The way that we, as the executives of the federal government, manage the taxpayers' money sends a message to the people of America as well as to our trading partners and investors around the globe. When we control our spending, we are showing our citizens and the world that fiscal discipline is a priority on par with our policies that promote economic growth.

I'll talk more about fiscal discipline in a moment, but I'd like to start with a look at what we have recently achieved through pro-growth economic policies.

Well-timed tax cuts, combined with sound monetary policy set by the Federal Reserve Board, have resulted in very good economic growth and, most importantly, continual job creation. The economy has created over 2.7 million jobs since May of 2003. And while

job growth can never be fast enough for those looking for work, the steady pace of job creation has been an unmistakable sign of an economy that has recovered from very tough times, and is now expanding.

Whenever I speak with my counterparts in the G7, I am reminded that the American economy is the envy of the world. Our recovery and growth, our successful dedication to entrepreneurship – all these things are admired, and increasingly emulated, by our G7 partners.

Is it any wonder that they want to learn the secret to our economic resiliency? A quick look at the facts reveals much to be envied: GDP growth for 2004 was 4.4 percent. Our economy has posted steady job gains for twenty straight months. The unemployment rate is down to 5.2 percent – lower than the average rate of the 1970s, 1980s and 1990s. Real after-tax income is up by over eleven percent since the end of 2000 and household wealth is at an all-time high. Inflation, interest rates, and mortgage rates remain at low levels. Homeownership rates are at record highs.

Tax cuts can be hard on budgets and deficits in the short term, but if the tax cuts are geared toward improving incentives there are long-term benefits as well as short-term ones, and this fact has been well illustrated by these outstanding economic results.

I point to this record because it is so important that we continue on a pro-growth path. Continued economic growth is needed, and will be needed, to continue to improve our standard of living and until every worker in America who is still looking for a job can find one.

For example, we've got to make the President's growth-enhancing tax cuts permanent – and that is included in this budget. The President's Panel on Tax Reform was also created with economic growth in mind. It is a group of some of the best minds in our country, and they'll be looking critically at the entire existing code and coming up with proposals that would make it fairer, less complex, and more pro-growth.

While the Panel is working on that historic task, our efforts to grow the American economy will continue in many other areas – I am particularly interested in legislation that will reduce the burden of frivolous lawsuits on our economy – and this budget is part of the Administration's overall pro-growth policy agenda.

As I already mentioned, economic growth is good for our country for the jobs it creates and the prosperity it spreads. But it is also, importantly, part of a winning strategy on deficit reduction – one of the top priorities of this budget – because economic growth increases Treasury receipts.

Treasury receipts are rising – in the second half of calendar 2004, individual income tax revenue is up 10.5 percent versus the same period in 2003 – and will continue to rise, as long as we have economic growth. That must be accompanied, as I emphasized earlier,

by strict fiscal discipline. That is why the President's budget proposes real savings. I know it will have its critics as a result, but its frugality is essential.

Let me be very clear on this: we have deficits and they are unwelcome. But we are not under-taxed and higher taxes will not be the solution to reducing deficits. Fiscal discipline, combined with economic growth, is the correct path.

Using this approach, we are making headway on deficit reduction, and we're on track to halve the deficit by 2009. The deficit is also forecast to fall to 3.0 percent of GDP in 2006 and to 1.5 percent by 2009, well below the 40-year historical average of 2.3 percent of GDP.

The 2004 deficit came in at 3.6 percent of GDP – nearly a full percentage point lower than had been projected. And the 2005 deficit is projected to show another decline.

While we are pleased with this progress, we recognize that more needs to be done.

We need to make the tough choices on spending and stand steadfast in our commitment to continuing economic growth in order to see that deficit whittled down.

We also need to look at our long-term deficit situation. I spoke earlier about transparency, specifically the honesty of this budget, which deals openly with the needs of the times in which we live, from the war on terror to the need for continuing growth.

In the interest of honesty and transparency, I encourage all of us to follow the politically courageous leadership of our President by looking at, and dealing with, the $10.4 trillion deficit facing our children and grandchildren in the form of an unsustainable Social Security program.

The program is an important institution, a sacred trust, and it worked well for the times in which it was designed. It is, however, doomed by our country's demographics and in need of wise and effective reform.

The arithmetic is simple. As people live longer and have had fewer children, the ratio of workers paying into the system and retirees taking benefits out has dwindled dramatically. We had 16 workers paying into a system for every one beneficiary in 1950, and today we have just three workers for every beneficiary. That ratio will drop to two-to-one by the time today's young workers retire.

We all must agree that this demographic reality exists, that this problem exists. Social Security is secure for today's retirees and for those nearing retirement, it will not change for those people who are 55 and over... but it is offering empty promises to future generations. When today's young workers begin to retire in 2042, the system will be exhausted and bankrupt.

it is the future of the program that President Bush is concerned about, and it is the future of the program that we must address, this year, here on Capitol Hill. I echo the President's State of the Union Address in saying that we must join together to strengthen and save Social Security.

We can, and should, do this without increasing payroll taxes. The level of increases that would be necessary, if we maintain the status quo, would have a terrible impact on our economy. It would negatively impact economic growth; jobs would be lost. We don't have to go that way.

We can, and should, reform the system in a way that encourages younger generations of workers to build a nest egg that they own and control and can pass on to their loved ones.

Saving Social Security is an undertaking of historic proportions. We have hard work ahead of us as we strive for consensus in the name of younger generations.

We also have hard work ahead of us when it comes to strengthening the fundamentals of our economy: deficit reduction, good fiscal policy, energy policy, lawsuit abuse reform, and encouraging savings.

I appreciate that this Administration has an ambitious agenda… but it is a good one, worth the work it will take to move forward, together, on it.

Let's start by passing this responsible, pro-growth budget.

Thank you for having me here today; I'm pleased to take your questions now.

Chairman GREGG. The hearing is adjourned.
[Whereupon, at 11:59 a.m., the committee was adjourned.]

Brief Statement
By Senator Mike Enzi
2/10/05 @ 10:00 a.m.

Michael B. Enzi

Thank you, Mr. Chairman, for holding today's hearing.

And, thank you, Secretary Snow for coming to the Hill again to testify before this Committee. I am looking forward to hearing your views on the President's budget and his proposals to strengthen America's economy and protect our troops abroad and our citizens at home.

Last week, the President laid out an ambitious agenda that will take the will of Congress to carry out. We are faced with decisions today that will determine the well-being of our children and our economy well into the future. The way I see it, this hearing is about the President's proposals on tax reform, Social Security and holding the line on spending.

First, let's talk about spending. The role of this committee is to set a cap on spending that will give our authorizers and our appropriators enough money to fund our top priorities. The President has proposed a limit of about $840 billion in discretionary spending, which is an increase of about 2.1 percent. I believe the President has set a fiscally responsible limit; and I hope we can maintain his fiscal discipline in the coming weeks. Additionally, I believe we also need to practice fiscal discipline when it comes to mandatory spending. Currently, mandatory spending accounts for more than half of all Federal spending. This Committee must take the necessary steps to put in place strong budget enforcement mechanisms that will help keep mandatory spending under control.

I'd also like to talk about making the tax cuts permanent and reforming Social Security. I believe both are absolutely necessary.

The tax relief provided since 2001 has led to steady growth in GDP, record gains in productivity, record highs in home ownership and household wealth, and low levels of inflation and unemployment. It has led to the creation of over 2.7 million jobs and real increases in revenues to the Federal pot. That's one of the things that frustrates me. The tax relief helped businesses invest and families save, which in turn leads to higher business growth, higher wages, and real increases in federal revenues. Treasury receipts are on the rise because of the economic growth spurred by the tax relief.

Unfortunately, our method of accounting doesn't recognize those dynamics over time. Instead, we focus on how much money the Federal government would have made last year had we not given our small businesses and families the tax relief they so desperately needed. I am hopeful my colleagues will come to recognize that the tax relief we gave to working families and businesses over the last four years has not been a waste of Federal resources. It has provided real and tangible benefits to millions of

American's at every level of income.

With respect to Social Security, we have a long road ahead of us. I am very interested in hearing your views, Mr. Secretary, on the President's proposal to reform this massive entitlement program. As I understand it, if we don't do something now, by 2042, the program will be bankrupt. The President has proposed a plan that is estimated to cost $754 billion over 10 years beginning in 2009. What if we don't act now? How will that number change if we delay our reform efforts for five, ten or twenty years? Won't the cost of making this system financially stable only increase with time? Won't we still have to make tough decisions about benefits and taxes in 2018, when the system begins collecting less in taxes than it pays in benefits, in 2042, when the trust fund runs out of money, and further on down the road? I believe we need to begin answering these questions with an open and honest dialogue aimed at fixing the problem rather than at scaring the American public. Over the coming weeks, I look forward to hearing more about the President's proposal and working with my colleagues on both sides of the aisle to make Social Security reform a reality.

Thank you again, Secretary Snow, for being with us today and I look forward to your testimony.

# Questions for the Record to U.S. Treasury Secretary John Snow Senate Budget Committee FY2006 Revenue Proposals 4/22/05

**ENERGY EFFECT ON THE ECONOMY**
**Domenici**

**QUESTION 1**

This is from an exchange between Senator Domenici and Secretary Snow during the hearing. Senator Domenici asked if the Secretary could provide information to his questions, which are below.

*Senator Domenici.* Mr. Secretary, we understand that, but that is almost stopped. That occurred because the changing nature of what caused productivity gains here. We used new equipment and the like which used less energy. I do not know if that is going to continue, but could you supply us, whenever you get it, with the 5- and 10- year projections on what you assume in the budget on energy, and then answer in that what you assume energy, the condition of energy, what impact it will have on the American economy? Could that be an answer, would it have a drag, and if you can find out how much of a drag, we would like to know that.

*Secretary Snow.* We do know that higher energy prices are a drag. They act like a tax.

*Senator Domenici.* Would you put that together with the other?

*Secretary Snow.* We will, absolutely.

*Senator Domenici.* Thank you, Mr. Chairman.

**ANSWER:**

- The Administration relies on a wide variety of sources and methods to generate economic assumptions for the budget. On energy, we regularly consult Department of Energy experts to develop the forecast. The budget assumptions are generally close to the most recently released Energy Information Administration (EIA) projections for oil prices.

- EIA has just released the *2005 Annual Energy Outlook.* Because the outlook for crude oil prices was particularly cloudy when EIA was developing their long-term projections in the fourth quarter of 2004, EIA produced several sets of crude oil price projections. The price assumption used in the budget is similar to the EIA projection labeled "The October Oil Futures Case." That projection is "*an extrapolation of oil prices loosely corresponding to the recent mid-term profile of prices on the NYMEX futures market*" (*EIA Annual Energy Outlook,* page 44)

- In this projection, world oil prices remain high in 2005 (more than $8 higher on average than in 2004). After that EIA assumes that oil prices will generally trend lower in the near term and begin to rise in real terms in 2010. The rise after 2010 is gradual and not large enough to bring nominal prices back to 2005 levels by 2015, even allowing for economy-wide inflation of about 2.5 percent.

- The EIA projection is consistent with the belief that a large part of the run-up in prices in 2004 was due to temporary factors. Natural disasters – Hurricane Ivan, for example -- speculation brought on by geopolitical uncertainty, and other supply disruptions played a role in raising oil prices sharply in 2004. These factors are widely expected to reverse themselves eventually, although we will likely continue to feel their effects in 2005. In addition, an unusual burst of demand – particularly from Asia influenced oil prices in 2004. In the longer term, EIA believes that "*world crude oil prices will decline as growth in consumption slows and producers increase their productive capacity and output in response to current high prices.*" (EIA Annual Energy Outlook 2005, page 2.)

- Specifically, in this October Oil Futures Case, EIA projects that the nominal refiner acquisition cost (RAC) of imported oil would average about $45.50 in 2005, fall to

just under $36 per barrel in 2010, and rise to just under $42 per barrel in 2015. When the projection was done, EIA estimated the RAC for imported oil would average almost $38 in 2004, while the actual figure is about $36 per barrel. The imported RAC is usually $2-$3 below the more widely-quoted price of West Texas Intermediate crude oil, and that differential widened to about $5.50 for all of 2004 and about $8 at the end of 2004.

- In short, if the EIA and the October futures market projections are correct, receding oil prices could have a small positive effect on economic growth and could also help to keep inflation in check in the near term. The longer term rise in real oil prices seen by EIA for 2010-2015 is relatively small, and would not likely be a noticeable factor in the outlook for growth.

- The sharp increases in oil prices since 2002 have played a role in slowing economic growth. EIA estimates that the rise in oil prices in 1999Q1 through 2000Q3 reduced growth by about 0.3-to-0.4 percentage point annually in those years, when prices rose from a yearly low of about $11 per barrel to nearly $30 per barrel before receding later in 2000. Other analysts have estimated a similar effect on GDP growth over the 2003 and 2004 from the rise in oil prices in the last two years.

**ENERGY TAX CREDITS**
**Senator Judd Gregg**

**QUESTION 2A**

The President proposes tax incentives totaling \$3.6 billion through 2010 in order to increase the use of clean renewable energy and energy-efficient technologies. These energy tax incentives include credits for the purchase of hybrid and fuel-cell vehicles, residential solar heating systems, energy produced from landfill gas, electricity produced from alternative energy sources (i.e. wind and biomass), and combined heat and power systems. How many people do you estimate will take advantage of these credits to purchase hybrid and fuel-cell vehicles, solar heating systems, etc.?

**ANSWER:**
Although estimates of the number of taxpayers who will take advantage of the credits is highly uncertain, we believe that between 0.8 million and 1.4 million taxpayers will be able to take advantage of these credits over the course of a 10 year period.

**QUESTION 2B**
Will these incentives help us decrease our dependence on foreign sources of energy?

**ANSWER:**
The President's FY 2006 Budget includes tax incentives totaling \$6.7 billion over 10 years. These are dedicated incentives for alternative and renewable fuels, conservation, and energy efficiency. Not only will these incentives help to reduce our nation's reliance on foreign sources of energy, they will help to reduce emissions of air pollutants and carbon dioxide.

The tax credits for hybrid and fuel cell vehicles have the greatest potential impact on reducing our dependence on foreign energy because the transportation sector now accounts for 67 percent of the U.S. oil consumption. The proposed hybrid and fuel cell vehicle credits will encourage the purchase of highly fuel-efficient vehicles that incorporate advanced automotive technologies and will help to move hybrid and fuel cell vehicles from the laboratory to the highway. There will be substantial fuel savings as these vehicles enter the market in greater numbers.

In addition, the Administration's other tax proposals for wind, biomass, and landfill gas energy, combined heat and power, residential solar power and nuclear decommissioning funds may help to reduce our nation's reliance on traditional fossil fuel, which includes natural gas. Although domestic wells provide for most of our current natural gas needs, in the future we may need to import more natural gas to keep up with domestic demand. The alternative sources of energy that the Administration is encouraging will lessen our need for imported energy.

**ENTERPRISE ZONES**
**Senator Jim Bunning**

**QUESTION 3**
This was an exchange between Senator Bunning and Secretary Snow during the hearing. Secretary Snow made reference to enterprise zone tax incentives during the hearing, and Senator Bunnings office requests that this information be a part of the record.

Senator Bunning. Under the current—I do not want to get into a confrontation—but under the current set up, Renewal Communities give tax breaks to companies to move there.
Secretary Snow. Right.
Senator Bunning. Are you saying that those things that you talked about would do likewise? In other words, the new zones you are talking about?
Secretary Snow. Yes. There is a provision for income tax exclusion inside these—tax advantages inside the zones for enterprises inside the zones, but I will give you a full layout on it once I understand it better myself.

**ANSWER**
A number of America's neighborhoods have lost a significant portion of their economic base as a result of our changing economy, for example, due to loss of manufacturing or textile employment, and are now in the process of transitioning to a more diverse, broad-based, 21st century economy. The Administration's opportunity zone proposal would ease that transition by targeting Federal resources and encouraging new and existing businesses to invest in these areas.

The Administration's opportunity zone proposal would create incentives for existing firms within an opportunity zone to remain within the zone and expand operations, for existing firms to move into an opportunity zone, and for new firms to start up within an opportunity zone. These incentives primarily come in the form of reducing the taxes for qualified businesses located within opportunity zones and are described below. These tax incentives would be in effect from January 1, 2006, to December 31, 2015.

*Exclusion of 25 percent of taxable income for certain opportunity zone businesses.* A business would be allowed to exclude 25 percent of its taxable income if (1) it qualified as an "opportunity zone business" and (2) it satisfied a $5 million gross receipts test.

The definition of an opportunity zone business generally would be based on the definition of a "qualified active low-income community business" for purposes of the new markets tax credit, treating opportunity zones as low-income communities. The $5 million gross receipts test would be satisfied if the average annual gross receipts of the business for the three-taxable-year period ending with the prior taxable year did not exceed $5 million.

*Additional section 179 expensing.* An opportunity zone business would be allowed to

expense the cost of section 179 property that is qualified zone property, up to an additional $100,000 above the amounts generally available under section 179.

*Commercial revitalization deduction.* A commercial revitalization deduction for improving nonresidential real property would be available for opportunity zones in a manner similar to the deduction for renewal communities. A $12 million annual cap on these deductions would apply to each opportunity zone.

*Wage credit.* Individuals who live and work in an opportunity zone would constitute a new target group with respect to wages earned within the zone under a combined work opportunity tax credit and welfare-to-work tax credit. The credit would normally apply to the first $6,000 in cash wages at a rate of 25 percent for workers employed between 120 and 400 hours and at a rate of 40 percent for workers employed more than 400 hours.

In addition to these specific tax incentives for opportunity zones, individuals, organizations, and governments within an opportunity zone would receive special consideration when applying for new markets tax credits and other Federal community development, job training, and education programs.

The Secretary of Commerce would select 40 opportunity zones through a competitive process. Applicants would have to demonstrate that the local community's economic base is in transition, as indicated by a declining job base and labor force, and other measure, during the past decade. Empowerment zones and renewal communities would be eligible to apply for opportunity zone status, but would be required to relinquish their current status and benefits once selected. Opportunity zone benefits for converted empowerment zones and renewal communities would expire on December 31, 2009.

Enterprise communities would also be eligible to apply for opportunity zone status. Aside from automatically being eligible to apply, enterprise communities that are selected to be opportunity zones would be treated as other areas that do not belong to either an empowerment zone or a renewal community.

**CDFI**
**Senator Sarbanes**

**QUESTION 4A**

Mr. Secretary, I am perplexed by the proposal in the Administration's FY2006 budget to move the CDFI Fund grant programs to the Commerce Department and eliminate the funding for its competitive grant programs. The CDFI is perfectly situated at the Treasury Department. I understand that the Administration's FY06 budget includes recommendations that the competitive grant programs of the CDFI Fund (Technical Assistance and Financial Assistance; Bank Enterprise Award program; and the CDFI Native Initiatives) be consolidated along with 17 other unrelated community development programs under a unified grant-making entity administered by the Commerce Department entitled, "Strengthening America's Communities Initiative." The FY2006 budget also eliminates funding for these incredibly successful CDFI competitive grant programs. The only funding that the CDFI Fund at Treasury would receive in FY06 would be $8 million to administer the New Markets Tax Credit program and manage its current portfolio of awards.

I am perplexed by this decision. The CDFI Fund is very unique. It was created in 1994 to foster a nationwide network of community development financial institutions and has been successful in encouraging the revitalization of distressed communities with very limited federal resources. According to Treasury officials, for every dollar that the CDFI Fund invests in a local CDFI through its grant program, the CDFI leverages $21 in private sector investment. I am concerned that there is no guarantee that the new grant making entity at the Commerce Department will appreciate the unique role played by CDFIs in leveraging private sector investments.

***Please explain:***

Why are the CDFI Fund's grant programs being consolidated with a host of other community development programs, when there is very little, if any, overlap between the CDFI Fund grant programs and other community development programs?

**ANSWER:**

Although the manner in which CDFI accomplishes its mission is unique - through improved access to financial services - the underlying objective is not unlike any of the other consolidated programs from the various cabinet agencies proposed to be consolidated at the Department of Commerce, which holds a primary mission of economic opportunity. Commerce has shown great skill in managing its programs and in greatly leveraging private sector investment. Nothing would preclude the CDFI industry from being eligible sub-recipients of "Strengthening America's Communities" grant funds from communities and states that receive funding.

**QUESTION 4B**
Why is the Administration eliminating specific funding for the technical and financial assistance and CDFI Native American Initiatives which have proven to be very successful?

**ANSWER:**
**The Administration believes that a more targeted, performance based Federal grant program at the Commerce Department will better serve the communities most in need of assistance. Simplifying funding streams that are available for communities most in need is important to the Administration and eligibility criteria is one of the forthcoming items in the legislative proposal for the "Strengthening America's Communities" Initiative.**

**International Economics**
**Senator Judd Gregg**

**QUESTION 5**

The U.S. gives roughly $21 billion dollars to international organizations such as the World Bank, which in turn funds programs in developing nations. Although these organizations collect money from many donor nations, their outlays are measured and distributed in U.S. dollars. Many of those recipient countries in turn use that money to buy U.S. goods. In today's world economy (with the dollar very weak when measured against most major currencies), the donations to developing countries do not buy as much as they would if the dollar was stronger.

1) How does the value of the dollar influence effectiveness of the U.S.'s donations to institutions such as the World Bank?
2) What long term impact could a continuing weak dollar have on U.S. leadership in these institutions?

UST Answer:

*How does the value of the dollar influence effectiveness of the U.S.'s donations to institutions such as the World Bank?*

The overwhelming majority of donors provide contributions to the World Bank denominated in Special Drawing Rights (SDRs), whose value is based on a basket of key international currencies. Donor national currencies can and have fluctuated widely against the SDR over time, and thus the effect tends to even out over time. Given these historical fluctuations, donors tend to report their contributions in their national currencies.

Since the Thirteenth Replenishment of the International Development Association (IDA-13) was reached in June 2002, the dollar has depreciated by approximately 14 percent relative to the SDR. This means that U.S. contributions to the Fourteenth IDA Replenishment, which was reached in February 2005, would have to increase by 14 percent in dollar terms to remain constant in SDR terms. On the other hand, the Euro-zone countries witnessed a 16 percent appreciation vis-à-vis the SDR since June 2002. Consequently, these countries' SDR-denominated contributions would increase by 16 percent if they provided the same amount of Euros as in the IDA-13 period.

It should be noted, however, that the currency situation was reversed when the IDA-13 Agreement was negotiated in 2002. The dollar had appreciated vis-à-vis the SDR by roughly 5% and the Euro had depreciated.

As for developing country purchasing power, the current value of the dollar could impact how many European goods and services countries are able to purchase. Clearly, the lower dollar value would not impact dollar-denominated purchases. In fact, there actually could be increased demand for dollar-denominated purchases since European

exports would be less competitive; however, such an impact would be difficult to quantify.

*What long term impact could a continuing weak dollar have on U.S. leadership in these institutions?*

The Bush Administration continues to follow a strong dollar policy, and will take measures consistent with this policy.

As noted above, currency fluctuations tend to even out over time and hence the long-term effect of today's dollar value is unlikely to be significant and in any case is impossible to predict.

The U.S. remains the largest shareholder at the World Bank, with a voting share of 16 percent at the International Bank for Reconstruction and Development (IBRD) and 14 percent at IDA. The second largest shareholder is Japan, which has a voting share of 8 percent at the IBRD and 11 percent at IDA.

**Money Laundering**
**Senator Sarbanes**

**QUESTION 6**

Mr. Secretary, the Banking Committee, of which I am ranking member, has heard testimony from several senior Treasury officials about extremely inadequate audit coverage for Bank Secrecy Act compliance by casinos and money service businesses; the latter type of financial institution includes money remitters—including the so-called hawalas thought to be involved in the clandestine movement of funds and identified by the 9/11 Commission as raising important problems in connections with terrorist funding. The category also includes sellers of money orders and currency exchange houses. Responsibility for compliance has been delegated to the Internal Revenue Service. How much money does the President's budget earmark for enhanced compliance audits in this area?

a) If no money is earmarked, what is the reason, given the national security risks involved and the need to treat all parts of the financial sector evenly in enforcing the nation's anti-money laundering controls?
b) If some money is earmarked, how many additional personnel are contemplated to be added with the earmarked funds? Will the personnel work solely on BSA compliance? What will be the total number of personnel devoted to this function at IRSA within the Small Business/Self-Employed Division, excluding members of the Criminal Investigation Division and IRS computer service functions, such as those at the Detroit Computing Center? Do you believe this is a sufficient number for the tasks involved?

**Response:** The President's budget for FY 2006 includes an IRS initiative for an increase of 240 revenue agent full-time equivalents (FTEs) to combat non-compliance. Twenty-five percent of that initiative (60 FTEs) will be devoted to enhancing Bank Secrecy Act (BSA) compliance, including increased Title 31 and 8300 examinations. With the addition of these 60 new revenue agents, the IRS expects to have 487 personnel in its Small Business/Self-Employed (SB/SE) Division working solely on BSA compliance. In addition, through a recent appropriation, FinCEN's newly established Office of Compliance is expecting to increase its staff from four employees to twenty-two by the end of fiscal year 2005, in an effort to meet its responsibility to support and, as appropriate, oversee the agencies with delegated BSA examination authority, including the IRS. The combination of these staffing increases for both IRS and FinCEN will help better position Treasury to execute its BSA compliance responsibilities.

To reflect the increased level of importance that the IRS has placed on BSA compliance activity, a new Fraud/BSA organization was set up on October 1, 2004, reporting directly to the SB/SE Commissioner. In recent months, the Fraud/BSA leadership has made significant operational changes to improve the efficiency and effectiveness of the organization. These changes, many of which

are being coordinated with Treasury's FinCEN organization, are as follows:

- Moving responsibility for identifying BSA workload and building these cases from the general Examination program to the Fraud/BSA organization. We expect this focused operation, which will be fully operational by October 1, 2005, to result in improved case selection and results.
- Working with the Criminal Investigation Division to improve the process for making fraud referrals, including their involvement in the training for our revenue agents.
- Piloting the centralized examination of major money services businesses (MSBs) at the entity's corporate headquarters level. Five such examinations are currently under way, with plans to begin additional examinations later in 2005.
- Introducing concurrent examinations of all MSBs located within specific ZIP Codes, selected in coordination with other law enforcement agencies. In addition to examining the MSBs for BSA compliance, this saturation approach allows our BSA examiners to identify individuals with unusual patterns of financial activity which fall below the reporting threshold. IRS initially has introduced these examinations in Chicago and Detroit. Other cities under consideration include New York, Miami and Houston.
- Working with FinCEN's newly established Office of Compliance to finalize an information sharing agreement that provides for the routine exchange of BSA compliance information, including information concerning financial institutions identified as having significant BSA compliance deficiencies or violations.
- Consulting with FinCEN to ensure appropriate coordination on cases involving Title 31 penalties and to request further consideration of IRS' need to access Suspicious Activity Reports (SARs) for civil purposes.
- Working with FinCEN and the Conference of State Bank Supervisors on a Memorandum of Understanding (MOU) to enhance information sharing with the states and, thereby, leverage limited resources. Now that the three organizations have reached agreement on this MOU, it is ready to be proposed to the states.

Based on the outcome of these ongoing changes, IRS will determine its needs for additional BSA resources in FY 2007 and beyond.

**FINANCIAL EDUCATION**
**Sen. Sarbanes**

**QUESTION 7A**

Next, I want to ask a question about the Office of Financial Education at the Treasury. As you know this Office is tasked with assisting the Financial Literacy and Education Commission. I was pleased to see in the President's summary budget document that both the Office and the Commission were highlighted. The budget states, on page 252: "The 2006 Budget continues its commitment to the Office of Financial Education, which facilitates private sector efforts to raise the level of financial literacy of Americans. Treasury coordinates the financial education efforts of 20 federal agencies."

Please tell me, what is the Administration's budget request for the Office of Financial Education in FY06? How does this compare to the budget, as requested and as enacted, of the Office of Financial Education in FY05?

**ANSWER**

The Office of Financial Education operates annually within a range of $550,000 - $700,000. The Administration proposes a reduction to this program in FY 2006 of $334,000 out of a $1,000,000 annual office budget. As a result, the office will maintain current funding levels.

**QUESTION 7B**

What is the Administration's budget request for the Financial Literacy and Education Commission in FY06? How does this compare to the budget, as requested and as enacted, of the Financial Literacy and Education Commission in FY05?

**ANSWER**

The Administration did not request funds for the Financial Literacy and Education Commission in the FY06 budget. Departmental Offices (DO) did not request any funding for the Financial Literacy and Education Commission in the FY05 President's Budget; however, Congress enacted $1,000,000 for the program in the DO Salaries and Expenses annual account.

**QUESTION 7C**

How do these budget levels reflect the commitment to the Office of Financial Education that is mentioned in the President's budget?

**ANSWER**

The funding received in the FY05 enacted budget was a one-time funding source. This is $1,000,000 more than the FY04 operating level and will be used for the implementation and development of a national strategy and additional mandated deliverables required by the Fair and Accurate Credit Transactions Act of 2003.

**PRA PLAN COSTS BEYOND 2015**
**Senator Byrd**

<u>QUESTION 8A:</u>

**The OMB estimates that $754 billion is necessary to finance the president's plan through 2015. What are the projected costs five years and ten years beyond that window?**

**ANSWER**

- The Social Security Actuary has scored the effect of the Administration's proposed PRAs taken in isolation only through 2015. Beyond 2015, it is impossible to estimate the effects without knowing what a comprehensive reform package would ultimately look like. We can estimate through 2015 because the President has said there will be no changes in Social Security benefits for people who were born before 1950. The first of those people reach age 65 in 2015.

<u>QUESTION 8B</u>

**How do those projections square with Vice President Cheney's assertion, as well as projections by independent budget analysts, that individual accounts within Social Security will cost trillions?**

**ANSWER:**

- Implementing PRAs will not result in a significant increase in the total financial promises of the federal government. In effect, it translates a portion of future defined benefits into explicit publicly-held debt. In the long-run, there is minimal additional cost to the government.

<u>QUESTION 8C</u>

If the President is serious about Social Security reform, he should have sent Congress a legislative proposal. The President not only declined to submit a bill, but he did not include a dime in his budget to reform the program. When will the President submit a draft bill to Congress, and when will its full costs be released to the public?

**<u>ANSWER</u>**

- The President wants to work with Congress to develop a final Social Security reform plan.

**RECOUPING INITIAL PRA COSTS**
**Senator Byrd**

QUESTION 9A:

**The Bush Administration has argued that costs incurred in the short-term to transition to individual accounts would be offset by the savings realized in the future. Under the President's proposal, when would those costs be recouped? How would those costs be recouped—through benefits cuts or tax increases?**

ANSWER

- There should be no long-term cost of implementing PRAs, because we are just swapping a promise of future defined benefits for explicit publicly-held debt of equal value. For the most part, the government's total promises are unchanged, and the only change comes from families who receive inherited balances who would have received nothing under current law. The upfront borrowing will be recouped as those workers who choose to hold PRAs draw retirement benefits from their own accounts that may partially replace a "traditional" benefit.

QUESTION 9B:

**What level of cuts in guaranteed benefits would the President accept to finance individual accounts? How much debt is the President willing to incur?**

- The current system is financially unsustainable and needs to be fixed. The system cannot afford to pay currently promised benefits, so adjustments must be made to put Social Security on a sound footing. The President has stated that he looks forward to working with Congress to develop a complete Social Security reform proposal.
- It is important to understand that in most Social Security proposals that include personal accounts, there are no net benefit cuts that are a result of creating personal accounts. Many proposals must adjust benefits in order to balance the traditional system, which is unsustainable under current law. This situation exists irrespective of personal accounts. Because participants in personal accounts voluntarily exchange some benefits from the traditional system in order to receive the opportunity to benefit from a personal account, the personal accounts themselves do not materially affect the finances of the traditional system, and thus require no additional benefit changes.

**RAISING CAP ON INCOME SUBJECT TO TAX; TAX TREATMENT OF PRA INCOME**
**Senator Byrd**

**QUESTION 10A:**

**President Bush has said he opposes increasing the payroll tax to finance future benefits. What are the views of the Administration in regard to raising the cap on the level of income subject to the payroll tax?**

- Raising the cap on income subject to the payroll tax is one of many ideas that is before Congress in the process of formulating a comprehensive Social Security reform plan. The President has stated that raising the payroll tax rate is not an acceptable outcome because of the harm it would do to today's workers and the American economy.

**QUESTION 10B**
**How would gains accrued in individual accounts be treated for tax purposes? Would those Social Security benefits be subject to taxation under the President's plan?**

**ANSWER**

- While the exact tax treatment of the accounts is still being developed, our expectation is they will be treated in a manner similar to traditional Social Security benefits.

**MINIMUM SS BENEFITS; PROGRESSIVITY**
**Senator Byrd**

QUESTION 11A:

**President Bush told workers in his State of the Union with regard to personal accounts "Your money will grow, over time, at a greater rate than anything the current system can deliver." However, the stock market has ups and downs. If workers retire when the stock market is down, they are in deep trouble. They cannot wait for the market to recover. What guarantee would the Administration support to ensure a minimum benefit from an individual account?**

ANSWER

- First, it is important to remember that participation in the personal accounts would be strictly voluntary. No individual need accept any more risk than they wish.
- Second, those workers who choose to contribute to PRAs will be able to choose from a variety of investments, including stocks, corporate bonds, and TIPS, inflation protected government bonds. A life-cycle investment option will also be available that adjusts an account holder's portfolio toward less volatile assets as the worker nears retirement. In fact, PRA balances would be automatically invested in the life cycle portfolio when a worker reaches age 47, unless the worker and his or her spouse specifically opted out by signing a waiver form stating they are aware of the risks involved. By choosing to contribute to a PRA, individuals' are making a choice that owning and investing their own funds will bring them a better return than the current system.
- An individual would have the opportunity to receive a higher rate of return than the current system can offer by investing in bond and stock funds. There is no historical precedent for the bond and stock markets returning, over a 40-year working career, a rate of return that is lower than the risk-free Treasury bond rate.
- In fact, the current system itself is at risk because it is unsustainable. PRA's would improve the current system in a substantial way by allowing those workers who contribute to them to pass along their nest eggs to their loved ones. Under the current system, many workers pay for a working lifetime into the system, and do not receive any benefit if they happen to untimely pass away before they're 65 years old – that represents a negative return of 100%.
- Under the proposals the Administration has put forward, an individual worker has the option of receiving a portion of future benefits from their personal account instead of from the traditional system. In effect, they trade a traditional benefit for a personal account benefit, which we expect will be at least as large. But in some instances, there are no benefits to offset the benefit of a personal account, because there are many families that receive nothing under current Social Security

law. For example, consider a family where the primary wage earner dies, the surviving spouse is not of eligibility age, and the children are older than 18. Such a family might receive nothing from the current Social Security system until the spouse reaches retirement age, but under the President's proposal they would have the benefit of inheriting a personal account. The Administration believes it is important that these inheritance rights be established within the Social Security system, which would indeed provide some families with benefits who now receive none.

- Those who wish to have a "guaranteed benefit" from their personal account can achieve this by remaining invested solely in Treasury bonds.

**QUESTION 11B**
**Under the President's plan, what guarantee would workers have of receiving the level of benefits scheduled under current law?**

**ANSWER:**

- As currently structured, the program cannot afford to pay benefits at the scheduled rate. In fact, under current law, if the Congress does not act, benefits will have to be cut by 26% in 2041.
- That is why, for workers born after 1950, changes will have to be made to the traditional system. The PRA portion of a reformed program will be entirely voluntary, and those who choose it will have the opportunity to own their benefits personally, and the Government will not be able to take them away.

**QUESTION 11C:**
**What happens to workers whose individual account have not accrued enough money to guarantee a benefit that will keep them above the poverty level? What happens to a worker whose account has not accrued enough to buy an annuity to guarantee a payment above the poverty line?**

**ANSWER:**

The current system does not guarantee a benefit above the poverty line, because benefits are proportional to the beneficiary's income over her working years. PRAs are projected to increase workers' expected benefits, but cannot fully change this situation, especially when considering the facts that the personal accounts are voluntary, and that some workers may wish to replicate their traditional Social Security benefits by investing in Treasury bonds. We believe that PRAs will reduce poverty among the elderly by increasing expected benefits relative to current law.

**QUESTION 11D**
**How can personal accounts ensure the progressivity of the current system, and what would the Administration support to ensure the system remains progressive?**

**ANSWER:**

For those who choose to contribute to a PRA, the baseline from which the adjustment for PRA contributions will be made is still the progressive Social Security benefit. While changes to the traditional program are needed to make it sustainable, those changes will preserve the progressivity of benefits.

# TRANSPARENCY OF BUDGET MEASURES

**WEDNESDAY, FEBRUARY 16, 2005**

U.S. SENATE,
COMMITTEE ON THE BUDGET,
*Washington, DC.*

The committee met, pursuant to notice, at 10:03 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Wayne Allard, presiding.

Present: Senators Allard, Domenici, Ensign, Conrad, and Nelson.

Staff present: Scott B. Gudes, Majority Staff Director; and Jim Hearn.

Staff present: Mary Ann Naylor, Staff Director; and John Righter.

## OPENING STATEMENT OF ACTING CHAIRMAN SENATOR WAYNE ALLARD

Senator ALLARD. I am going to go ahead and call the Budget Committee to order. We will have other members, I am sure, that will be attending this morning. We have some pretty stiff competition as far as testimony in front of the other committees, but I think we have the real expert here before us.

Dr. Holtz-Eakin, I look forward to hearing your comments. And despite some of the competition, this does remain a very, very important hearing. We are going to be examining some of the fiscal demands of Government in the short term, and probably even more importantly in the long term, as they evolve over a number of decades, weighing the costs and the benefits of every dollar taxed and spent. And I think that is the role of this committee.

I do not think we can underestimate the value of understanding the Nation's fiscal exposure, particularly when we look at such programs such as Medicare, which I think is very obvious. We have the other two big programs out there that we share concern with, that is, things like Medicaid and Social Security. But I anticipate we will focus most of our time on Medicare. But we also have other long-term liabilities out there that I am concerned about, and I think other members are concerned about, for example, the Pension Benefit Guaranty Corporation, and things like AFDIC and FDIC and other programs that I do not think some Members of Congress have thought too much about our future obligations, but potentially there are future exposures out there, and we need to at least give them some thought.

I think each one of these trust funds—or programs, or trust funds in some cases, where we have these significant challenges and demands, I think we need to spend some time to study them,

and I think that is what the chairman of the Budget Committee, Senator Gregg, had in mind when he set up this hearing. So we will try and focus on that, and I want to thank in advance Senator Conrad for his help in conducting this hearing with us this morning. This is a bipartisan effort this morning.

With that, let me call on Senator Conrad for a few comments.

**OPENING STATEMENT OF RANKING MEMBER KENT CONRAD**

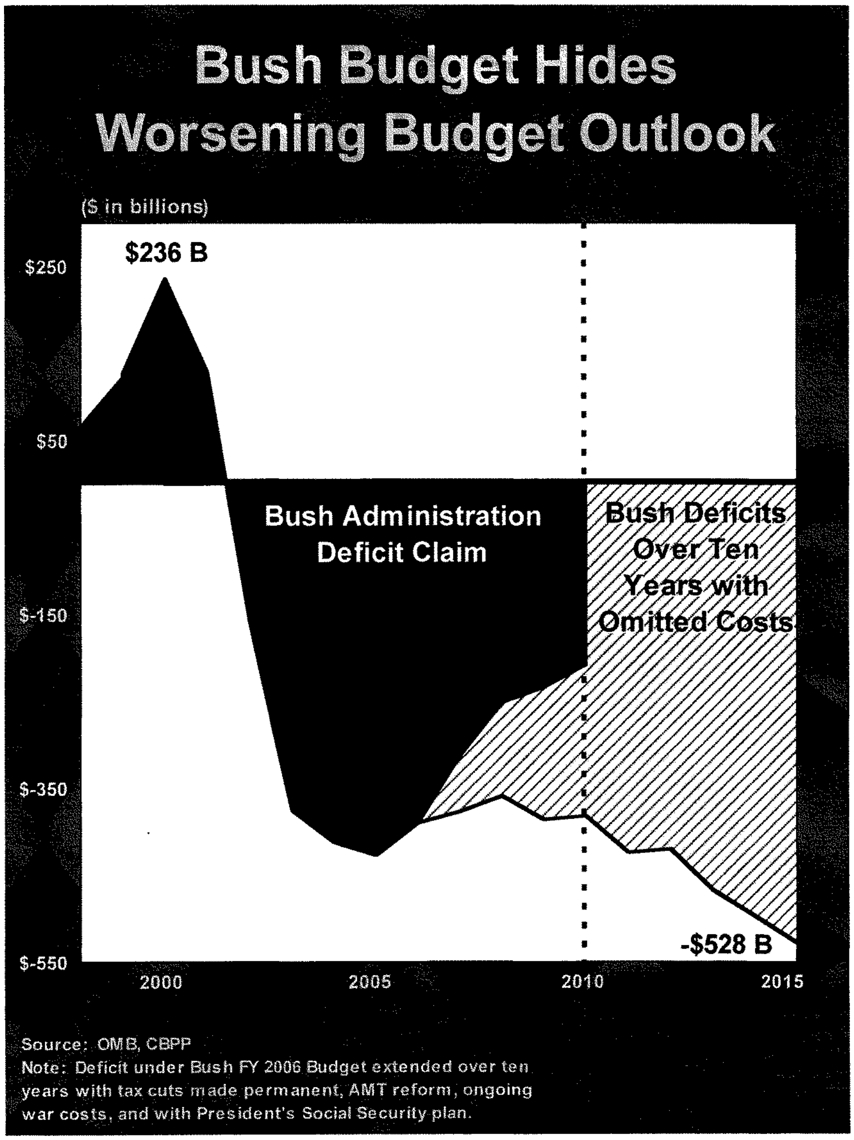
Senator CONRAD. First of all, I thank Senator Allard, who is acting as chairman for us this morning. I agree with you. I think this is very, very important because we are starting to talk now about our long-term obligations and the shortfall that we are experiencing in those long-term obligations.

Let me just put this up. This was recently in Business Week. This is what they said: "There are no good reasons for hiding the cost of all these endeavors or denying their consequences. New private retirement accounts could cost $1.5 trillion from 2011 to 2015 and add $100 billion a year to the budget deficit for 20 years. Making tax cuts permanent could cost $2 trillion. Fixing the alternative minimum tax could cost an additional $500 billion. These are real numbers that should be included in any real budget. If President Bush believes the policies proposed are best for the Nation, then he should lead an honest dialog about how we should pay for them."

Mr. Chairman and Director Holtz-Eakin, I agree with that. I think we have a runaway train on our hands, not just in the short term, but more seriously, I think, in the long term.


What's Left Out of Bush Budget
Full 10-Year Numbers
Funding for Ongoing Iraq Costs Beyond FY 2005
AMT Reform
Social Security Privatization Transition Costs
Spending Policy Details Beyond FY 2006 (Discretionary)

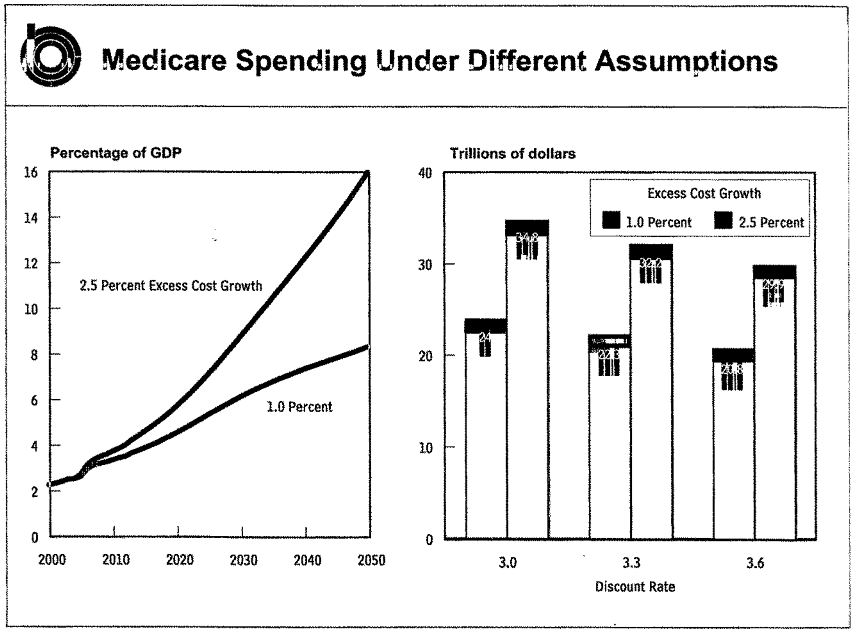
Let's go to the next chart. As I look at the budget and I see what is left out—full 10-year numbers are left out. We all know what that means because the tax cuts go up dramatically in cost the second five years. There is no funding included for the Iraq war beyond this next fiscal year; alternative minimum tax reform; Social Security privatization transition costs. I am told now that the cost of Social Security privatization costs over 20 years is approaching $5 trillion. And we have no discretionary spending policy details past fiscal year 2006. Highly unusual.



Bush Budget Hides
Worsening Budget Outlook
($ in billions)
$236 B
$250
$50
$-150
$-350
$-550
Bush Administration
Deficit Claim
Bush Deficits
Over Ten
Years with
Omitted Costs
-$528 B
2000
2005
2010
2015
Source: OMB, CBPP
Note: Deficit under Bush FY 2006 Budget extended over ten years with tax cuts made permanent, AMT reform, ongoing war costs, and with President's Social Security plan.

Let me go to the next chart. When we put all these things back in, here is what we see. The President's budget shows the deficit improving, but when we put all the things back in that have been left out, we see the deficit improving slightly over the next 4 or 5 years, but then going back in the wrong direction. And all of this kind of hides our real long-term situation.

The Comptroller General was here the other day and testified we have $43 trillion of obligations that have not been covered, of unfunded obligations, $43 trillion, most of that is for Medicare, $27 trillion for Medicare. Social Security was about one-eighth that amount.


Medicare Spending Under Different Assumptions
Percentage of GDP
2.5 Percent Excess Cost Growth
1.0 Percent
2000
2010
2020
2030
2040
2050
Trillions of dollars
Excess Cost Growth
1.0 Percent
2.5 Percent
3.0
3.3
3.6
Discount Rate

My own conclusion is we have to be addressing all of these things. We have to be addressing the imbalances in Medicare and Medicaid and Social Security. We have to address the budget deficits. All of that I think is going to require not only spending discipline, but fundamental tax reform.

One other comment I would like to make because I think this is also critical to our understanding of the problem. The long-term economic growth assumptions of the Social Security Administration are 1.8 percent a year. That is what they are forecasting the economic growth will be over the next 75 years. If we look at the previous 75 years, growth has averaged, as I understand it, about 3.4 percent. Now, the major difference is we have a dramatic reduction in new entrants to the work force. But that is really a very pessimistic outlook.

I asked the Social Security Administration to tell us what would happen if productivity growth was 2.6 percent instead of 1.6 percent. They told me that Social Security's funding shortfall would decline by more than half, from 1.8 percent of payroll to 0.82 percent of taxable payroll. If average productivity growth doubled to 3.2 percent, then Social Security's funding shortfall would decline 90 percent—90 percent.

So these estimates really matter, and it does strike me that they are extraordinarily pessimistic. It is one of the things I would like to talk to Dr. Holtz-Eakin about today.

Notwithstanding any of that, we have still got a problem. We have still got a problem. The problem is the baby-boom generation that is going to dramatically increase the number of people eligible for these programs. As I have indicated, the Social Security problem of whatever dimension needs to be addressed. A far bigger problem is Medicare and, frankly, Medicaid is eating the States alive.

So I am delighted we are having this hearing today, and I look forward to the testimony of Dr. Holtz-Eakin.

Senator ALLARD. With that, Dr. Holtz-Eakin, welcome and we look forward to your comments.

**STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE**

Mr. HOLTZ-EAKIN. Thank you for the chance for the Congressional Budget Office to be here today. Mr. Chairman, Senator Conrad, we have some written testimony which I would like to submit for the record. It makes a few points, and it says that the Congress creates programs for their benefits, and it constructs budgets to reflect their costs. The focus of that testimony is that the key decision is to spend money and that that spending can be in many different forms. It can be in the form of mandatory programs, which last for a long time and which are currently the big numbers that attract everyone's attention. It can take the form of spending only under certain circumstances, as would be the case for a loan guarantee or an insurance program. Or it could be something that looks like a short duration but quite certain, such as annual appropriations.

In each case, spending is a good measure of the cost of that program, and the spending should be presented as close as possible to

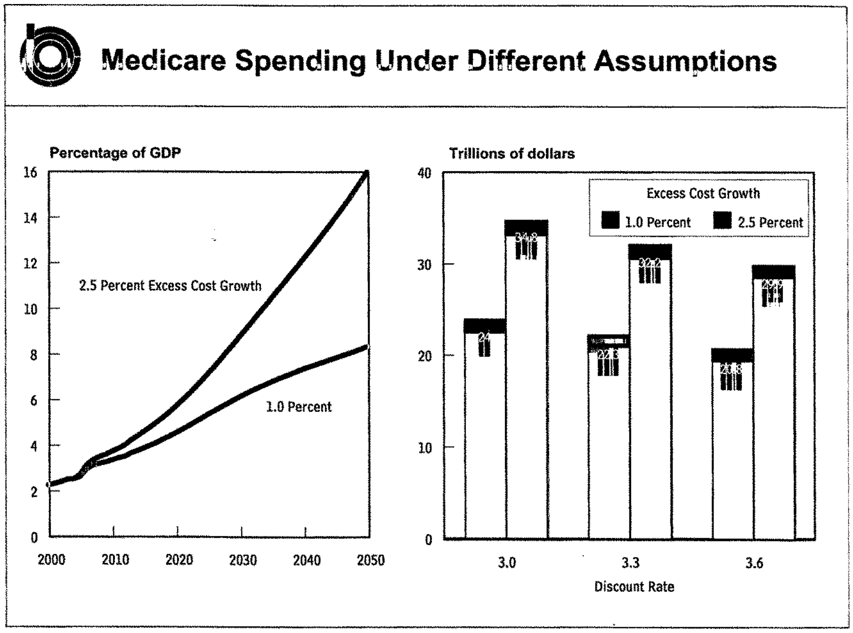
its true economic cost, to level the playing field both across budgetary items and also between the public and the private sector so that a fair comparison of benefits and costs is possible in evaluating programs. I leave it to you to go through that testimony. I would be happy to answer any questions on it.

Given the title of today's hearing, the transparency of budget measures, I wanted to focus my remarks on a slightly different topic, and that is, recently there has been, I think, a fair amount of well placed concern and attention placed on transparency in private sector accounting. In the private sector corporate accounting, there has been a lot of attention on better disclosure and presentation of the exact status of affairs. And in light of that, there is a temptation, I believe, to import into discussions of Federal Government finance the private sector model wholesale and in what I hope is—and in what I fear is a not—well thought out fashion. And my concerns come in two forms. The first is on principle. I think one should be cautious about importing this because there is no private firm that has the power to print money. Neither is there a private firm that has the power to tax. The Federal Government is a very different entity, and its most powerful asset is the sovereign power to tax. And thinking about presentation of budgets from a private sector standpoint can send you down to the wrong place.

One of the pieces where I think that shows up the most is the notion of an unfunded liability. Let me spend a couple minutes talking about my reservations on this concept taken at face value.

The first is, just so we are on the same page, how these are calculated. If you would take Medicare, for example, one would count up all the spending that is promised under Medicare where you count future years less than present years, discount them, and count them at less than dollar for dollar. But you add up all this spending over some horizon. You add up all the dedicated revenues over some horizon. And you look at the difference and label that an unfunded liability.

What are the problems with that? Well, first, as I mentioned, is that at conceptual levels nothing is unfunded at the Federal level. There is always the power to raise taxes and fill that gap right up to the point of economic irrationality, at which point the taxes are so detrimental that you actually harm yourself. So I think it is unlike the private sector where an unfunded liability requires the infusion of new resources because the commitment is made and the funds are not in place. Here funds can be brought into place in a much different fashion.


Medicare Spending Under Different Assumptions
Percentage of GDP
16
14
12
10
8
6
4
2
0
2000
2010
2020
2030
2040
2050
2.5 Percent Excess Cost Growth
1.0 Percent
Trillions of dollars
40
30
20
10
0
Excess Cost Growth
1.0 Percent
2.5 Percent
24
34.8
32.2
20.8
3.0
3.3
3.6
Discount Rate

No. 2, I think we have to be careful with the word "liability." I noticed you used "obligation." I think that is sensible. The firm liability of the U.S. Government is outstanding Treasury securities, backed by the full faith and credit of the United States. There is an enormous continuum of obligations, commitments, and promises to pay resources out in Federal programs, and some rise to a level of firmness that they should properly appear in the budget, and others do not, where it might be more appropriate to know about them, have some information, but not actually place them on the budget. One can think of areas such as implicit guarantees for future disasters where you would not want to actually put that on the budget, but you would want to be cognizant of the size versus very firm commitments where once they are made, a contract for a student loan, a contract for a long guarantee, it would be appropriate to put the recognition on the budget itself. So the notion of liability I think is slipperier than a lot of discussions make it seem.

Then there are some practical difficulties, and I think the Medicare example is an important one for thinking about this in the Federal context. The first practical difficulty from a budget standpoint is that you lose some information in going to these unfunded liability kinds of measures. In the chart that I have distributed and that we have here, we have on the left side a replication of some work we did in 2003 on the long-term budget outlook. It shows the future spending under Medicare as a fraction of GDP between now and 2050, depending on how fast health care costs grow. The top line is growing at 2.5 percent faster than income per capita; the bottom line is 1 percent faster. So those are the numbers that we have in our long-term budget outlook.

Senator CONRAD. Mr. Chairman, might I just ask him to repeat that? Could you repeat, the 2.5 percent relates to what?

Mr. HOLTZ-EAKIN. We have historically had this, what I think of as a horse race between costs and resources—costs, spending per beneficiary, and resources, income per capita, GDP per capita. Historically, in the past three decades, costs have risen 2.5 percent faster per year than has income per capita. That gets the label "excess cost growth," and the blue line shows the future of Medicare if one simply extrapolates that historical pattern with the new demography of getting older, and something which shows a sharp rise from a bit above 2 percent of GDP now to just under 16 percent.

The green line assumes a future where costs grow more slowly, 1 percent faster than income per capita, an assumption used by the Medicare trustees. The left panel shows two alternative futures. The right panel shows a series of present value calculations of the type that would be in an unfunded liability notion.

Consistent with what I said earlier, I left out the taxes. It's the spending that matters. These are present values of spending. Blue bars on the right correspond to the fast cost growth on the left; green bars, the slower cost growth.

From this, I think you can draw a couple of lessons. The first lesson is the bars on the right tell you nothing about how fast this problem hits, and so by definition, when you add things up over the future and you present them now, you give up the timing, which is actually central to budgetary planning, anticipating the impor-

tance of problems at different points in time. The left diagram gives you some timing.

The second lesson that one could draw is these computations are very sensitive to discount rates. The middle bar in each pair is the 3.3 real interest rate that CBO uses for its long-term projections at the moment. The actuaries use 3.0 for Social Security. I would argue by the standards of science those are the same number. We simply do not know. But you can see that there is a very big difference in the height of those bars. A slight change in the discount rate either down, to the left, or up, to the right, moves the numerical value tremendously.

It is not the case that by bringing these numbers to the present there is a truth revealed. It is not about truth. It is, again, an estimate of the current cost of the obligation that has been incurred by this program. And they suffer the uncertainty that one would put in in any projection.

Then, finally, if you just had those numbers, I do not think you would be able to discern readily whether you had the 2.5 percent fast growth or the slower growth. So it would not necessarily be the case that by moving to this kind of a system one would increase transparency. Indeed, it might be harder to figure out what is behind the numbers. Looking at the left, you can see which grows fast and which grows slow.

I think those are practical difficulties in moving wholesale toward this kind of a presentation for Federal budgeting and reasons why, given that Medicare, Medicaid, health programs are the big numbers that face us in the Federal budget, one would want to move cautiously in adopting this model for a whole variety of reasons.

Then I will close by saying that I think it is obvious that more information about the future and the scope of the Federal budget is important, and more information is something that the CBO and many others would be happy to provide. The real issue is how to incorporate it into the formal budget process. You can imagine a range of possibilities where at the request of the Budget Committee we could provide a longer-term estimate or some alternative presentation. You could automatically provide such a presentation for mandatory programs, for example, build it into the process in that way so the information becomes available, but the current Federal budget process is unchanged. Or you could move a little more toward a formal incorporation by raising points of order, having some threshold for, "Whoa, that is big," that would trigger a point of order and cause an automatic discussion of the size of a particular bill.

Finally, one could—and I emphasize the trepidation with which I personally would go there—One could incorporate these kinds of numbers into the budget process in a formal and numerical fashion. I think given the practical difficulties of doing so, that would be a step that the Congress should only take with a great deal of caution and study.

We are happy to be here today, and I look forward to answering your questions.

Senator ALLARD. Well, thank you for your testimony.

You know, this is one of the debates we have, the Members of Congress, is how far out should you project your estimates. I think generally the term applies, the further out you go, the more variables that get kicked in that are unpredictable, and how can you bring any kind of certainty to that process. I think sometimes we have a difficult time just figuring out what is going to happen within the same Congress, the first session to the second session.

What kind of tools would you think we could use in trying to make some long-term projections?

Mr. HOLTZ-EAKIN. Well, the tools that we are using at the moment are to take current law programs, extrapolate them, and examine the sensitivity of those projections to alternative assumptions that are important. As Senator Conrad mentioned in his opening remarks, key uncertainties in the future of the Social Security program would include fertility, disability, mortality, and immigration on the demography side. And on the economics, what is the future of real wage growth as driven by productivity?

So the tools that one can provide are both the best point estimate that an analyst can provide, but also some rough sensitivity analysis, in some cases formal sensitivity analysis that shows the bands of uncertainty from those sources. That would allow the Congress to see which solutions were robust to the uncertainties and which were not. And since we cannot know the future exactly, that is the kind of thing that you can bring to the decisionmaking.

Senator ALLARD. One of the things that we have to struggle with is that this committee and your budget office have limited resources. And as we try and look at all these long-term obligations, it strikes me that it is going to outstrip our resources that we have, and perhaps maybe you can help us begin to set some priorities. What programs do you think we ought to be looking at now, what programs in the intermediate future and some that could be put out a little bit longer when we look at some of our long-term obligations?

Mr. HOLTZ-EAKIN. I think that you can divide, as our written statement did, the challenges into two rough areas. The first are the long-term costs of current programs, particularly in Medicare, Medicaid and Social Security, where regardless of the precise numbers, we know the shape of the future driven by demography in large part, and the spending lines point north to a degree that is unlikely to be sustainable.

And then a second group of programs that merit attention but which are quite likely to be smaller in nature are those things that are associated with contingencies and uncertainty, things like the PBGC, where we do not—we know that the magnitude will not be comparable in scope to Medicare, but when it will arrive is very uncertain. And prudently knowing that it could arrive is an important part of the budget process.

Senator ALLARD. So your suggestion then is that we look at those where we are looking at larger future obligations first, and I am gathering from your comments—I am just trying to simplify this—that because they are huger obligations, the sooner we begin to address those, then the easier it is going to be to solve those that are such huge ones; that if we put them off, then they almost get to

be at the point where they are unsolvable. That is basically what you are saying.

Mr. HOLTZ-EAKIN. As a policy matter, the big mandatory programs are a key place for focus. As a budget presentation matter, we can work on all—I mean, I am happy to volunteer the staff to work on everything simultaneously.

[Laughter.]

Senator ALLARD. OK. We will move ahead. I call on Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman. Again, thank you, Director Holtz-Eakin, for being here. Thank you for that very thoughtful presentation. I learned something here this morning. Actually, I learned quite a bit. So that was important testimony.

Explain for me, as you look ahead—let's remove ourselves from the language of whether it constitutes an unfunded liability or an unfunded obligation. To me the most important thing are the trend lines, where this is all headed.

If you were to characterize, as you look—and not based on the rules that are put on you formally, because you can only do projections based on current law. That is the requirement that is put on you. But based on your judgment of—your analysis these numbers. You spend a lot of time doing it, as do the members of this committee. You look at the trend lines on Medicare. You look at the trend lines on Social Security. You look at the revenue situation. You know the demographics of the baby-boom generation.

If you were to characterize our current circumstances in a budget sense—we have already got very large deficits; we have large demands on spending coming up; we have the President asking for substantial additional tax cuts—how would you characterize our long-term budget situation?

Mr. HOLTZ-EAKIN. I think our long-term budget situation is likely unsustainable. There is a long-term mismatch between the spending promised and the resources present to finance it, and the long-term spending promise could, in fact, be so large that one would not want to finance it as a matter of economic policy.

Senator CONRAD. Let's go to that statement, that the long-term commitments that are being made by our Government are unsustainable, in your judgment, and as a matter of economics might be unwise to keep. Why?

Mr. HOLTZ-EAKIN. Again, nothing is for sure, but if one thinks of the upper end of the risks, Medicare and Medicaid over the next 50 years rising to 21.3 percent of GDP, Social Security rising to 6.3 percent, we are at 27.6 percent; whatever the needs in defense might be; and we have not touched many of the things that most people consider the Federal Government budget—education, highways, welfare——

Senator CONRAD. Let me stop you there and put that in perspective for people, because we have people listening and this percentage of GDP probably gets lost on them. What is typically the total spending by the Federal Government as a share of GDP?

Mr. HOLTZ-EAKIN. Twenty percent has been the post-war average, so the——

Senator CONRAD. About 20 percent.

Mr. HOLTZ-EAKIN. The numbers I mentioned, Medicare and Medicaid, take up all of that. And then you are layering on top of it additional spending that would take us above the post-war average to somewhere in the vicinity of 30 percent. The post-war average on the tax side has been 18 percent of GDP. That strikes me as—it is certainly not a guarantee, but it is something that one would not want to sail into casually.

Senator CONRAD. Can we just repeat this? Because I think, you know, people listening, it is very important that they understand. Right now typically the Federal Government spends about 20 percent of gross domestic product.

Mr. HOLTZ-EAKIN. That is the post-war average.

Senator CONRAD. That is the post-war average. And what you are telling us here today is that there is a potential for Medicare and Medicaid alone to spend 20 percent of gross domestic product. Is that correct?

Mr. HOLTZ-EAKIN. That is a straight-line extrapolation of history. So something has to change in order for that not to occur.

Senator CONRAD. We are in a circumstance in which Medicare and Medicaid alone could consume what has typically been all of Federal spending. That would be no money for Social Security. That would be no money for national defense. That would be no money for parks or education or all of the other priorities of Government.

Mr. HOLTZ-EAKIN. That is right.

Senator CONRAD. And Social Security on that same trend line would be 6.5 percent of gross domestic product. Is that true?

Mr. HOLTZ-EAKIN. Yes.

Senator CONRAD. So just those, Medicare, Medicaid, Social Security, 26.6 percent of gross domestic product being consumed by the Federal Government when the post-war average is 20 percent.

Mr. HOLTZ-EAKIN. Those are the numbers, and that is the risk that we face.

Senator CONRAD. Well, it again speaks to, to me, the need to address all of these things collectively.

Senator ENSIGN. Senator, would you yield so I can ask a follow up question.

Senator ALLARD. His time is just about up.

Senator ENSIGN. Just to clarify and to add an additional number. What is the historical average of the rest of the budget as a percentage of GDP? In other words, you have Social Security which you just said in the future would account for about 30 percent, what would the total budget be as a percentage of GDP? You have just given us 26.5 percent just with Medicare, Medicare, and Social Security. Has historically everything else been 3.5 percent?

Mr. HOLTZ-EAKIN. Well, the history is less clean there because we have had this big shift over the post-war period. It used to be about two-thirds discretionary, one-third mandatory. Now we are at the other end of the spectrum. And so it is these big mandatory programs that we are talking about.

How big can you let the discretionary programs get is, you know, much more controlled on an annual basis, but if you took a third of the budget, you are looking at 6 percent of GDP, roughly. That is right now.

Senator ALLARD. I want to go back and give Senator Conrad an opportunity. You have 20 seconds left on your time, so if there is something you want to summarize?

Senator CONRAD. Thank you very much, Mr. Chairman, and thank you for the question, because I was going there myself, how does that all add up. And I think it just becomes very clear it does not add up.

What I wanted to take you back to is the economic question. Why would it be harmful to the economy for the Federal Government to be consuming 30 percent of gross domestic product? What would be the adverse effect?

Mr. HOLTZ-EAKIN. It is hard to imagine that we could maintain some of the key broad pillars, I mean, not details but the big picture, pieces of the U.S. economic success have been broadly a reliance on private markets and small contained Government financed by relatively low and efficient taxes. We would have a much larger Government. It would take over a greater fraction of the economy. It would necessarily have to have higher taxes, and to the extent that they were levied in an inefficient fashion, that would have an economic cost. That is well documented. And it may be the case that in those circumstances there would be a temptation—and this is an unknowable part of the future—to accomplish policy goals in other ways, using regulations and mandates, and that interferes with the flexibility of the economy.

So it is a future in which the overall scope of things becomes so large that it is hard to maintain the historic patterns that have been successful in the United States.

Senator ALLARD. Thank you.

Senator ENSIGN.

Senator ENSIGN. Thank you, Mr. Chairman. That was a great line of questioning. I want to followup with it because I think that the importance of this cannot be overstated. What Senator Conrad and Senator Allard talked about underscores that, if we do not make changes sooner rather than later we will find ourselves in a difficult position. I mean, if we were at the point where our budget consensus, say 30, 33 percent of our gross domestic product, we would have to have the revenues to equal that. Historically that's obviously difficult when we have been around 18, 19 percent historically as far as a percentage of GDP for purposes of taxes. If we had to finance that, the tax rate would be outrageously high in this country. But if you just continue on the current course, there is no way you change it. It goes back to studying the historical truth of democratically elected governments collapse? They collapse because people realize that they can vote people into office who will give them what they want. We are at that critical breaking point, I think, and the longer we wait, the less chance there is of truly fixing the system.

I want to talk about a couple of programs. Lets compare Social Security to Medicare and Medicaid. Social Security has unfunded liability that is small compared to Medicare and Medicaid. If we do not make changes to the new Medicare prescription drug benefit Part D right now, from what I understand, over the lifetime, we have huge unfunded liabilities. Do you know the number of the un-

funded liability on just the prescription drug benefit over an equivalent timeframe?

Mr. HOLTZ-EAKIN. Given my reservations about these numbers, I want to just put big bracket——

Senator ENSIGN. Just so we can compare apples with apples. You know, the numbers are what they are, but just so we can compare apples with apples.

Mr. HOLTZ-EAKIN. Drug spending is rising at about 8 percent per year at the end of our 10-year projection. The discount rate that one would apply to these kinds of calculations to do the unfunded is about 5–1/2 percent, treasuries plus inflation. That means that if you go over a long enough horizon, literally out to infinity, the cost of that bill is infinite because the costs are rising faster than the discount rate.

So to give you a number I would have to make an arbitrary assumption about when drug costs would begin to slow down and how much. I would have to get them down to under 5–1/2 percent in order to give you a number, and I would have to pick a date. One of the reasons I am nervous about embedding numbers like this in the Federal budget is they are really arbitrary. I am terribly aware of how difficult some of these estimates are, but they are far less arbitrary than something like that.

So it is a big number, I assure you. We could decide on how big a one you want.

[Laughter.]

Senator ENSIGN. I do not want a big one.

[Laughter.]

Senator ENSIGN. Just to further illustrate this, lets just go back to Social Security. We hear the year 2018 tossed out there, which is when the trust fund starts running into the red. As far as I am concerned, trust funds are phony and they are an accounting procedure. It is not like what most people really think of when they think about a trust fund where they actually have money in a savings account. We all know the kind of games that are played up here.

If we do not do anything, and it has continued to grow—let us go out to 2018 and we have not touched Social Security, we have not made any changes to the system, we have not cut benefits, we have not done anything because the chances of cutting benefits, well let's jsut say we know the politics of this, so we have not increased the rate of return or anything like that. Lets go right to where the trust fund starts turning upside down.

At that point, if we have not made any changes, what happens to the rest of the budget, Medicare, Medicaid, all of the discretionary spending? What happens to the rest of the budget at that point?

Mr. HOLTZ-EAKIN. First of all, the rest of the budget is growing rapidly, Medicaid and Medicare, and to honor the promises of Social Security you will have to find those resources in the rest of the budget. You will have to raise taxes. You will have to cut spending in the rest of the budget. You will have to go borrow more.

In Social Security in isolation you might feasibly imagine that, but for the budgetary picture as a whole it is hard to imagine you could borrow that kind of money.

Senator ENSIGN. At what point, how many years from now does that actually start becoming a reality? I gave you the 2018.

Mr. HOLTZ-EAKIN. 2010.

Senator ENSIGN. 2010 is when that——

Mr. HOLTZ-EAKIN. 2010 the Social Security surplus peeks in our estimates, but somewhere around there, and then it begins to diminish and pressure in the unified budget will begin to become more apparent. And people have different dates at which it becomes a problem, but that is the starting point for the diminishing cash surplus into the remainder of the budget.

Senator ENSIGN. Based on your experience on watching us up here on Capitol Hill and the proclivity to spending up here and not cutting spending, what is your best guess on what would happen to the rest of those programs? It would be borrowing, correct?

Mr. HOLTZ-EAKIN. An economist can give you two answers to anything, so the answers are as follows. One, people do things because of preferences, political or otherwise, and they do things because there are constraints. Even the United States cannot borrow infinitely large amounts of money every year and at some point the constraints will bind even if the Congress does not choose to change programs.

Senator ENSIGN. Bottom line is we are in trouble in the future if we do not make changes?

Mr. HOLTZ-EAKIN. Yes.

Senator ENSIGN. Thank you.

Senator ALLARD. Let me call on Senator Nelson.

Senator NELSON. Thank you, Mr. Chairman.

Hello again, doctor.

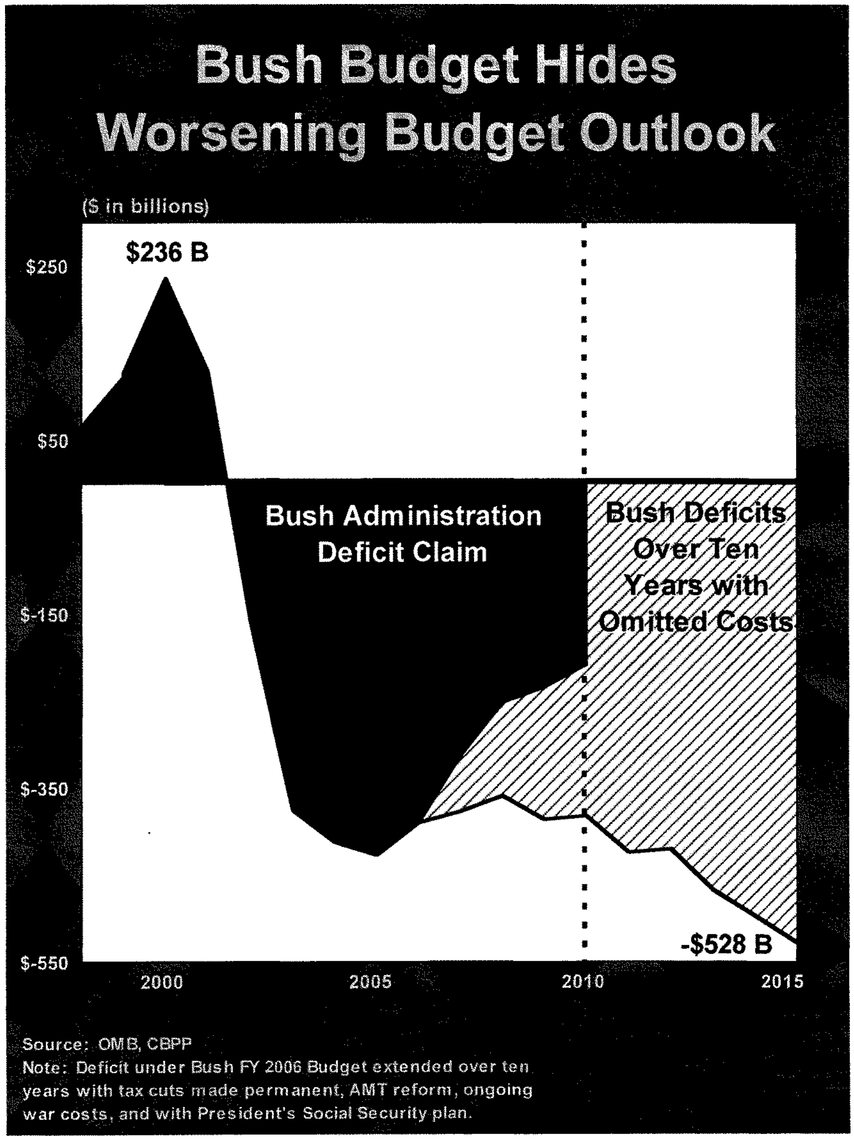
Mr. HOLTZ-EAKIN. Good morning.

Senator NELSON. Several times. I am just going to ask a simple question. Years ago I came to the House of Representatives, elected in 1978, shortly after the Budget Act was put in place. And it was put in place for the purpose of basically bringing the deficit under control. At first there was some success in the late 1980's. I believe that the deficit was brought to somewhere close to 20 or 25 billion dollars. Then in the decade of the 1980's it ballooned and we had a different situation. Of course you know the history in the 1990's. It was brought under control so that by the end of the decade of the 1990's the Federal budget achieved what we had been trying to achieve for 20 years, which was the budget came into balance, and then lo and behold, for a couple of years running we had a surplus.

I guess my concern is that the budgetary process does not mean anything any more if we do not come forth with the subject of this hearing, the transparency, the adequate numbers. You can deal only with the numbers that you are given, but looking at one of Senator Conrad's charts here, that if all of these things are not included—and of course we are getting ready to vote on this right now, and it is going to pass overwhelmingly because who is not going to support to money to support our troops—and if all these other things are not in the budget, and I am asking you I think a philosophical question, why are we going through this exercise if what is in front of us really is not a reflection of the reality? Would

you philosophize for us, make me feel any better about the budgetary process?


What's Left Out of Bush Budget
Full 10-Year Numbers
Funding for Ongoing Iraq Costs Beyond FY 2005
AMT Reform
Social Security Privatization Transition Costs
Spending Policy Details Beyond FY 2006 (Discretionary)



Bush Budget Hides
Worsening Budget Outlook
($ in billions)
$236 B
$250
$50
$-150
$-350
$-550
Bush Administration
Deficit Claim
Bush Deficits
Over Ten
Years with
Omitted Costs
-$528 B
2000
2005
2010
2015
Source: OMB, CBPP
Note: Deficit under Bush FY 2006 Budget extended over ten years with tax cuts made permanent, AMT reform, ongoing war costs, and with President's Social Security plan.

Mr. HOLTZ-EAKIN. People rarely come to the Budget Director to feel better.

[Laughter.]

Senator CONRAD. Or this committee.

[Laughter.]

Mr. HOLTZ-EAKIN. And to ask an economist to philosophize is a really dangerous business.

The purpose of the hearing I think is to ask the question, what should be in a congressional budget, how should it be entered, and how do you reflect the operations of the Federal Government?

When there is a firm enough commitment it should be entered in the budget, there is no doubt about that. And budgets, I believe, should best be thought of in their plain vanilla English sense. They are planning documents. You budget for things. And you should plan for the things that are most important.

Right now it is a different situation than it was 10 years ago. 10 years ago the hard work of the Congress put controls on discretionary spending. The peace dividend made it easier to do in the area of defense, and a revenue boom was a great bonus on top of it. We are 10 years way from that. We are 10 years closer to the retirement of the baby boom. We are unlikely to have a peace dividend in the near future, and the money in the Federal budget is not in the discretionary side.

So to the extent that business needs to be done differently going forward, I think it essentially has to involve finding a way to budget for the mandatory programs that are the biggest part of the Federal budget, that are the rapidly growing threats to the future, and I do not have a magic presentation or panacea. I have some reservations about some things that I see people talking about. I would be happy to work with this committee, certainly, who are the people most cognizant of these issues in my experience.

I do not know if that is good philosophy or not. I was not great at philosophy.

Senator NELSON. Senator Conrad, you are so eloquent in all of this. Would you make me feel better?

Senator CONRAD. I wish I could. You know, I really think we are on a long-term course which the Director describes as unsustainable, and these things are real. There is no question about it. Alternative minimum tax is quickly becoming a middle class tax trap, 3 million people affected now. It is going to be 30 to 40 million people affected. We are going to have to deal with it, and it costs money to do. It is not in the budget.

The war costs past September 30th of this year, the Congressional Budget Office tells us it is very substantial but it is not in the budget.

The cost of going to Social Security individual accounts or personal accounts, whatever one wants to call them, private accounts, has an enormous cost, and it is not in the budget.

I mean when we put the things back in the budget that the President is proposing it just further takes us into a swamp of red ink, and at the worst possible time, before the baby boomers start to retire. We know what is going to happen. We know that the number of people in this baby boom generation are going to double in very short order the number of people eligible for Social Security

and Medicare, and we know that Medicare costs are going up before we even consider the new numbers. The costs of medical treatment are going up far in excess of inflation. Is that not the case, Director Holtz-Eakin?

Mr. HOLTZ-EAKIN. Yes.

Senator CONRAD. So we are on a collision course. The more I come here the more I feel like I am in a sort of detached-from-reality state in the Congress and in working with the administration, because we know these things. It is not even a close call. We know that none of this adds up, and yet we act as though nothing is happening and really nothing needs to be done.

My own view is the work that we would have to do to put the country in a more secure position for the future is really quite stunning. To take on the challenge of the shortfalls in Medicare and Social Security and the existing budget deficits, coupled with the President's plan for even more tax cuts—none of it adds up. It does not even come close to adding up. And you know, I guess my most fervent wish would be that all of us, that the President say, OK, time out. Let us get everybody to bring forward their best ideas on how we deal with Medicare and Social Security and tax reform, because I think that has to be a piece of it, and I say that not as code words for a tax increase, I say to my colleagues. I say that because I truly believe our current tax system is hemorrhaging hundreds of billions of dollars a year that is owed that is not being paid.

I used to be a tax administrator. I see the estimates of the IRS that say $300 billion in 2001 was the tax gap. I do not think they are anywhere close to how big the tax gap is. I think it is much bigger. They are working on studies now that I think will reveal that. I do not think just jiggering around with the current tax system is going to fix a significant proportion of that. We have tried. We have tried to do that before. Senator Allard has been a part of those efforts. I have been part of those efforts.

But I think the agenda is really very, very significant, and yet we kind of are dealing with the edges of it, and the sooner we get on this much more ambitious agenda, the better for the country.

Senator ALLARD. Your time is expiring here. I would like to keep it rotating around. We will have another time to speak. We allowed you to go over almost 4 minutes, so I would just like to keep it rotating around.

Senator NELSON. May I make a concluding statement?

Senator ALLARD. You may, as long as it does not go over a few seconds.

[Laughter.]

Senator NELSON. It seems to me that what I thought of as you were speaking is that we just cannot solve this problem in this era, this atmosphere of highly partisan charged, "got ya" politics, that it is just like Social Security. You cannot solve that in this atmosphere. And it has got to be a coming together, and the only thing that I can think is from my own experience when Ronald Reagan and Tip O'Neill got together in the early 1980's and said, "We are going to do something about Social Security." And they had 6 months that they had to get it done because Social Security was going to run out of money for its payments, and they did it. And

they did it with a bipartisan commission that said "We are not going to play partisan politics." And they did it. I do not know how else we are going to solve this budgetary crisis until we get that kind of bipartisan atmosphere.

Thank you.

Senator ALLARD. Thank you.

I would like to assume some of my time now on this. We talk about resources that are available, and in your preparation I think you had taken great pains and effort to distinguish between obligations and unfunded obligations. When you use the term "unsustainable," are you not in a way talking about unfunded obligations?

Mr. HOLTZ-EAKIN. I use that term because I do not believe that if we attempted to fund them going to what is the ultimate resource, the U.S. economy, that we could do that by higher taxes without damaging that economy, that it would be a losing battle.

Senator ALLARD. Another source out there that we have not talked about in this discussion, and maybe you want to take a little time to do that, is one thing we can do is restructure some of the programs in order that you do not incur the future cost. Would you care to mention how that resource may be used in trying to cut down on some of our future obligations?

Mr. HOLTZ-EAKIN. I think in the end it will be the prerogative of the Congress to decide how to restructure the programs, but I think the numbers——

Senator ALLARD. Give us some ideas on some of the big ones.

Mr. HOLTZ-EAKIN. The numbers give you places to start. We know the big ones, Medicare and Medicaid. They are also the hardest of the mandatory programs because the underlying source of the increase is rising health care costs in the United States, not necessarily the structure of the programs alone, and that is not as well diagnosed as many other phenomenon. As a result, it is very difficult to pretend there is a list of solutions out there that one could pick off the menu and hand to the Congress. There I think progress will be incremental and involve lots of experimentation because necessarily we might spend more on health but we do not want to overspend.

Social Security next in line in terms of magnitude, very different, a program that is well understood, a program that in the end involves raising money in one part of the economy, delivering it to another, perhaps at a different point in time. There is a large menu of potential solutions to the financing and the policy objectives, a place the Congress is discussing right now. Moving down the line, there is the whole list of policy options in the areas of defense and other defense policy, annual appropriations, and then smaller mandatory programs, whether they be insurance, where I think the important thing is to recognize that when the Federal Government engages in the large number of financial transactions that it does it transfers but does not eliminate risk, and when it carries that risk on the Federal budget, it is implicitly carrying it on behalf of the taxpayers who are ultimately going to have to foot that bill, making conscious budgetary recognition of all the risks that the Federal Government has collected and is holding for the taxpayer.

It would be a step toward identifying which places were large and would be a way to go forward.

In the work we have done for the Budget Committees, as an example of that, we have looked at the America West loan guarantee, which under current budgetary treatment appears to be a profit center for the Federal Government because it ignores the market risk, but if you put the risk in there appropriately the way markets recognize it, it swings from being a $45 million profit center to a $25 million loss. Things like that I think will be useful in letting the budget reflect the relative magnitude so that the policy decisions can be made better.

Senator ALLARD. And I agree with our colleague from Florida, maybe some of this ought to be a bipartisan effort, but I think it serves reminding ourselves at this point in time that a third of this round figures is discretionary spending, which tends not to be as political as with the mandatory program which is two-thirds, and there is where we talk about the political part of it. And if we would take a position on spending on some of those programs, then the responsibility falls to the authorizing committee, not the appropriators to come up with some solutions as to how we can move these programs in a way in which our future obligations may not be quite as great, and that is a real challenge I think for the Congress.

The only way that I see something like that happen is it does have to be a bipartisan effort because you have to have more than a majority to move forward on most of this, and so you have to rely on some support coming out of the minority party to get that accomplished. My hope is that we can come on these really important mandatory spending, or entitlements, in a way that we can look at it. I know that some members in the Senate, more so out of the Democrat side than Republican side, have said, Look, you know, there is not any problem with Social Security. But I hear my colleague here, and I certainly believe, and I think most of the American people believe that there is truly a problem with Social Security and that the sooner we deal with that problem the easier it is going to be to resolve it in a satisfactory way. As you had commented earlier, the longer you put that off it almost gets to a point where it is impossible to solve.

Let me just kind of move on to another area, which I think has some potential sizable obligations on our Federal budget, but perhaps even more, it has some impact even on the marketplace, and that is what we call our Government sponsored enterprises. I serve on Banking Committee, for example, where we are looking at Fannie Mae and Freddie Mac, and those we see huge obligations, potential obligations out here, and that they are carrying a pretty sizable debt. I think somewhere around 1.6 trillion, 1.7 trillion is the figure that gets tossed out there.

What can we do legislatively to resolve this issue of implied obligation? We have not made a direct obligation to them, but everybody assumes that if something happens to Fannie Mae or Freddie Mac that that is going to be an obligation that the Government is going to pick up. What can we do legislatively to make it clear that those types of funds—and we can pick out several other examples, but I will just use those—what can we do legislatively to make sure

that it is understood out there that it is not necessarily going to be—that it is not a Federal future obligation?

Mr. HOLTZ-EAKIN. The implicit subsidy to the housing GSEs derives from an array of different features of the way they operate, the Presidential appointment of directors, the exemption from SEC registration requirements, the ability of banks to hold greater fractions of their securities as if the were treasuries, a line of credit at the U.S. Treasury. So there is a long list of things which contributes to this implicit subsidy. A process has begun and legislation could accelerate peeling back different aspects of those special and preferential treatments toward, and in the continuum of that, you get to a point where they are treated like any other private entity with comparable capital requirements, comparable registration requirements. That would sever it completely. Any movement in that direction would lessen this implicit guarantee.

Senator ALLARD. You fall into almost kind of this concept "too big to fail," and it seems to me that perhaps maybe on those kind of things if the more competition you got in there so that your entities are not quite so large, that perhaps maybe that could be part of our solution. I wonder if you might address that thought.

Mr. HOLTZ-EAKIN. "Too big to fail" is a market perception.

Senator ALLARD. It is.

Mr. HOLTZ-EAKIN. So you cannot control that directly. Indirectly you control it by more firmly putting in the same kind of regulatory environment that is meant to prevent failure, capital requirements, disclosure requirements, registration, all those things, so that the nature of the failure is one which is comparable in risk to other private entities, and then making sure that you are happy with the overall nature of the risks out there in the capital markets.

Senator ALLARD. My time has expired. I will now recognize Senator Ensign—I am sorry—Senator Conrad, you had some time.

Senator CONRAD. Let me just, on the Government sponsored enterprise, signal this note of warning because I remember very well when I was doing in my younger days real estate projects, and North Dakota and many parts of the country did not have access to national credit markets. And the advent of Fannie Mae and Freddie Mac made a dramatic difference in the credit available for real estate development, both housing and apartments and commercial. It is very important we not throw out the baby with the bath water here because I can tell you the difference in interest rates because of access to a national market versus being locked into local and regional markets is very dramatic. It has had a very beneficial effect.

Let me go to Medicare if I could because we have really identified that as the big enchilada in terms of our long-term obligations here. I just want to say for my colleagues, I really do think we need to have some kind of situation where we come together and everybody bring their best ideas.

Let me give four that I would advocate to my colleagues, and ask them to ask their staffs to be thinking about these things. First of all on Medicare, 5 percent of the people use 50 percent of the money, 5 percent use 50 percent. Is that roughly right, Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. Yes.

Senator CONRAD. I think we ought to focus on that 5 percent like a laser, and we ought to better coordinate their care because we could, I believe, achieve substantial savings as well as get better health care outcomes if we put a case manager on every one of their cases, and here is why. We did a pilot study with 22,000 patients. We put a case manager, a nurse on each one of their cases to better coordinate their care, and we reduced hospitalization 20 percent, achieved 40 percent savings and got better health care outcomes.

Now, why is that such a powerful idea? Because what is happening in modern life is people have multiple doctors, they are going to multiple health care providers. They have a doctor at their home place, they have a doctor down at the lake or at the beach, they have a lung doctor, they have a heart doctor, and they are getting medicine at the pharmacy and they are getting medicine out of town, and they are getting medicine in mail order. The problem is there is no central point of coordination for many of these cases. The result is they are taking too many prescriptions, they are getting duplicate tests, and many of these things actually harm the patient.

I'll just share a personal experience with my father-in-law, who passed away. We went down and spread out his prescription drugs, taking 16 different prescription drugs. I got on the line with the doctor, and I started reading him the drugs he was taking. He said, "Oh, my God, he shouldn't have been taking that for the last 3 years. He should not be taking that drug. That adversely interacts with the third drug you mentioned." And on and on it went. We found out 8 of the 16 drugs he was taking he should not have been taking.

I say that because that is exactly what they found with the 22,000 patients. They found that many of them were taking 15 to 16 prescription drugs, and half of them they should not have been taking. That led to all kinds of adverse interaction. It led to all kinds of hospitalization. In fact, that alone accounted for 20 percent of the hospitalization at enormous cost to Medicare and Medicaid.

The second idea I would offer is negotiating lower drug prices in Medicare. We do it in the Veterans Administration. I think we have to seriously revisit that.

The third idea I would offer is the $10 billion slush fund that the Health and Human Services Secretary has to sweeten the pot for private funds, private plans.

The fourth idea I would offer is the amount that private plans are costing over and above traditional Medicare, that is $40 billion. I just do not think we can afford these things. I think on the prescription drug plan that we ought to go revisit it. I voted for it. I sided with the administration, to some consternation of some of my best friends. But honestly, when it is up to $720 billion, Mr. Chairman, I think it deserves us going back in and see where we could save money. I think we ought to be doing that everywhere. We have to revisit everything we are doing.

Senator ALLARD. I thank you for your comments. I just want to take this up. I think it is more complicated than just having a case manager, frankly. I mean the State of Colorado from which I come, we have used case management as far as Medicaid is concerned.

But those costs continue to grow. The real problem is that 5 percent that utilize 50 percent of the resources in Medicaid, for example, those are all at the end of the life cycle decisions that are very, very difficult for any kind of Government agency to make, and those almost comes back in onto the family and the provider to come and do that. And where we have in Colorado said we have case managers in those cases, this is being monitored, there still is some duplication of drugs, even though you have that oversight. It helps, but I think that the savings from that gets oversold, and there are some real tough decisions on how you manage a medical case toward the end of the life cycle, which, you know, I would hate to see Government involved in, and I do not think you want to get involved in it. The Governor of Colorado has tried to get involved in those discussions to a huge political detriment.

So I think that we need to figure out some ways in which we can put the family and the family practitioner more in control of their own decisionmaking processes.

My view sometimes is the fear of lawsuits and taken to court because somebody makes this kind of decision. Somebody who feels like they do not have any flexibility in their decisionmaking process really does not add an awful lot to that.

Let me go ahead and call on Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

I think, Senator Conrad, you are exactly right though, and I said this about Medicare and Medicaid when Josh Bolten was here testifying, that I was disappointed that the administration did not propose more reform in its budget. I guess they are suggesting some reforms to Medicaid, but Medicare really is, between the two of those, a much bigger threat than Social Security. Social Security is a threat also. There is no question. There is a huge unfunded liability out there, but health care costs really, dwarf the Social Security problem that is looming out there in the future. I believe solutions have to be in a bipartisan fashion.

There are some things that really are noncontroversial and which do not go to philosophy, pretty simple things. Requiring Medicare and Medicaid to move to best practices. The reason you need to start with those is because all insurance companies and everybody else follows what Medicare and Medicaid do. Each one of the specialties right now, have identified various disease types and what the best practices are to follow. What the best drugs are. What the best tests to run are. How exactly to follow up. Requiring best practices can result in fairly substantial savings. The estimates are up to 20 to 35 percent of health care costs with that single reform.

Obviously, we disagree on tort reform. I have seen it right in my own State. Being right next door to California, which has had a very good medical liability reform law for a long time, and the difference between the liability costs in Las Vegas versus Los Angeles is just huge. A lot of our good doctors from Nevada are moving to California while, everybody else from California is moving to Nevada. The exception though is our doctors who are moving back to California because they can better afford to practice medicine there. We are losing a lot of really good specialists. We cannot get neurologists to take calls. There are all kinds of problems and the

costs are skyrocketing. So I believe any kind of a system in the future, in order to get costs contained, needs medical liability reform. We also have to eliminate medical errors.

Fundamentally, the other huge part of all of this is we have to devise a system where the patient is brought back into the accountability loop and understands cost. When you talked about case managers, today what has happened because of managed care and costs running out of control? Businesses said, hey, we need managed care. We need somebody to come in and control our costs. Managed care was originally supposed to be about managing care, now it is more about managing cost. The primary care physician used to be that case manager. They do not have time any more. It is about volume now. They have to try to see as many cases—Medicare's reimbursement is so pathetic, and because of the chances of being sued by the very low reimbursement, a lot of doctors are just saying, forget it. I am not going to even deal with those cases.

We do not allow doctors to charge, on Medicare, wealthy people more, to allow doctors to spend more time with them. If we could have health savings accounts, a lot of administrative costs. There is so much money spent in administration today. HSA's puts a person back into the accountability loop. The money is actually being spent from their account and the patient sees their balance. The doctor could spend more time with them. Patients could negotiate prices. We could do those types things. There are lots of ideas like that that I believe in the future that we could all come together on.

The question I wanted to ask, Dr. Holtz-Eakin, of you, has to do with the PBGC and the problems that are looming out there with so many pension plans. You know the ideas that have been put forward in Congress. Can you describe the problem to us? In the last year Congress passed a bill, and I was one of the few people who voted against it, that addressed pension under funding. Did that bill last year make the problem with the PBGC better or worse?

Mr. HOLTZ-EAKIN. The problem got worse because of the lower funding requirements for a couple of years. The problem comes in two pieces. One piece is the financial status, which is defined benefit pension plans are underfunded, broadly defined, and in some cases quite dramatically so. That is the broad underfunding issue.

The PBGC's problem, as the guarantor of these is that you can divide the underfunding into some legacy problems which steel companies fit into that, and there is not much you can do about that, and there are a variety of plans that look like that, versus those which going forward could be funded adequately and which, given the right incentives, would provide an option for people to have a DB plan in the private sector.

So the policy design issue is: can you segregate those policies aimed at the legacy and those which provide good incentives for DB plans going forward to fund themselves adequately? And if you raise, for example, a premium too high to cover the overall funding hole, you might make a DB plan so unattractive on a going forward basis that people would simply switch to defined contribution plans.

It is one of these issues where you have to distinguish between the past and the future and it is hard to do.

Senator ENSIGN. I mean I think most companies realize defined benefit plans are almost unsustainable into the long term. The rates of return are not what a lot of people have sold them.

But I think that one of the points to make here, obviously is that the taxpayer is going to end up holding the bill on a lot of these.

Mr. HOLTZ-EAKIN. The narrow liability of the PBGC is quite clear, but the concern of course in the broader scope is if there was a larger than expected event which caused lots of plans to show up at the PBGC, that Congress would feel compelled to pick up more of the tab.

Senator ENSIGN. Just a quick followup, and this is just clarification of this because I am now aware of this. Are the public employee pensions, are they guaranteed or backed up by PBGC? I do not know.

Mr. HOLTZ-EAKIN. No.

Senator ENSIGN. OK. I just did not know. Thank you.

Senator ALLARD. We are going to get ready to kind of wrap this up. I might check with Senator Conrad here on my right and see if he has any wrap up comments, then I will close the committee.

Senator CONRAD. First of all, I want to thank again Director Holtz-Eakin for being here, and thank Chairman Allard for filling in today and for conducting this hearing in a way that I think we had one of the best discussions we have had. I really do believe that this idea—and I would say to Senator Ensign, we have talked about more ideas here this morning about how to rein in some of these expenditures, than we have had a chance to talk about all year. I honestly believe if members had a chance to get together, bring their best ideas on saving money and improving care, it is amazing how many good ideas we would have.

I think some of my colleagues would be surprised. They think, well, you are against tort reform. I am not against tort reform if it is done in a way that I think is fair. In fact I think it is going to be an essential component of this whole package. But I have heard more good ideas here this morning than I have had a chance to hear at any of our previous sessions.

I very much hope that somehow we find a way to give a chance to every one of our colleagues to bring their best ideas and then implement them. I think we could make dramatic progress.

I thank the Chair.

Senator ALLARD. Thank you, Senator Conrad, for your comments and whatnot.

I would also like to thank you, Dr. Holtz-Eakin, for making here to share your expertise with us. We appreciate your good work. I personally think that we are going to have plenty of opportunity in the future to have some more discussion on these because these are very, very difficult issues that we are coming to struggle with. It has taken some leadership. I think it has taken the President to bring up these issues so that they come before the Congress, and I think now that discussion opened, we are finding more and more members saying, look, let us look at the total package and let us look at all of these issues. I think that it is members like Senator Conrad, who is thoughtful and keeps coming up with some novel problems that we have out there, novel solutions, and participation from members on this committee.

Hopefully, if we can get these out and begin to get them discussed, we can begin to address some of these solutions, which are not going to be easy, but they are important that we recognize them early on and begin to address them.

With that I would like to thank my colleagues for participating this morning. I would like to thank the witness, and those who have been following this debate. Thank you very much.

One other thing before I do adjourn the committee. We give to the end of the day for members to submit any additional questions that they may have to the staff, and then the staff will go ahead and process their responses. So I just ask the witness that if you get these additional questions, that you process them as fast as you possibly can, get them to the staff, and then we will be able to write up a full record on the committee proceedings.

[The prepared statement of Mr. Holtz-Eakin follows:]

# CBO TESTIMONY

Statement of
Douglas Holtz-Eakin
Director

## The Economic Costs of Long-Term Federal Obligations

before the
Committee on the Budget
United States Senate

February 16, 2005

*This statement is embargoed until 10:00 a.m. (EST) on Wednesday, February 16, 2005. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.*

**CONGRESSIONAL BUDGET OFFICE**
**SECOND AND D STREETS, S.W.**
**WASHINGTON, D.C. 20515**

Mr. Chairman and Members of the Committee, I appreciate the opportunity to appear before you today to discuss the budgetary portrayal of the federal government's fiscal outlook. The Congress adopts federal programs to achieve a wide range of objectives and uses the budget to indicate the costs of those policies. At the heart of the Congressional Budget Office's (CBO's) mission is the agency's responsibility to quantify the costs of federal programs and policies. Thus, with the strong caveat that I will be speaking only about costs while ignoring benefits, I want to make the following points in my statement today:

- Under current law, the U.S. government faces enormous foreseeable demands for federal spending over the long term. At the same time, it faces budgetary risks each year that are smaller in magnitude but difficult to predict.

- The commitment to spend a dollar has a cost. It makes no difference if the payment is charged to the general fund, a trust fund, or an enterprise fund. It does not matter if the dollar purchases goods and services, provides income support, or subsidizes an activity. The commitment has a cost—whether it is for a predictable outlay or for a potential outlay to liquidate a guarantee or to meet some other contingency.

- The value of government commitments is usually a good measure of the cost of government to the economy—its economic cost—because spending preempts the use of resources by others for other purposes. The dollars measure the value of forgone alternatives for the private sector and within the budget.

- The budgetary costs of federal commitments should reflect their economic costs. Even though the government commits to future spending in a variety of ways, including social and other insurance, pensions for federal workers, and the support of international organizations, all uses of funds can be compared in terms of their economic costs.

- It is timely to reassess the principles of federal budgeting to better measure economic costs. CBO has begun to provide long-term projections under a wide range of assumptions and to examine the effects of risks on spending and the costs of federal activities not currently shown in the budget.

Let me discuss each point in turn.

## The Long-Term Outlook for Government Spending

It will not be news to Members of this Committee that the United States faces severe fiscal demands in the decades ahead. Last year, total federal spending, excluding interest payments, was about 18 percent of the nation's income. CBO projects that, on the basis of current rules for benefits, federal spending is likely to rise to a much larger percentage of the nation's income by 2050 (see Table 1). Little disagreement exists about the cause of that situation. It stems primarily from

**Table 1.**

## Alternative Long-Term Paths for Primary Spending

(Percentage of GDP)

| | 2010 | 2030 | 2050 |
|---|---|---|---|
| High Spending Path | | | |
| Defense | 3.7 | 2.8 | 2.0 |
| Social Security[a] | 4.2 | 5.9 | 6.3 |
| Medicare and Medicaid | 5.3 | 11.5 | 21.3 |
| Other[b] | 4.9 | 4.3 | 3.4 |
| **Total** | **18.1** | **24.5** | **32.9** |
| Intermediate Spending Path | | | |
| Defense | 3.1 | 2.0 | 1.4 |
| Social Security[a] | 4.2 | 5.9 | 6.2 |
| Medicare and Medicaid | 4.8 | 8.4 | 11.5 |
| Other[b] | 4.9 | 4.5 | 4.2 |
| **Total** | **17.0** | **20.8** | **23.4** |
| Low Spending Path | | | |
| Defense | 3.1 | 2.0 | 1.4 |
| Social Security[a] | 4.2 | 5.9 | 6.1 |
| Medicare and Medicaid | 4.4 | 5.7 | 6.4 |
| Other | 4.8 | 3.5 | 2.5 |
| **Total** | **16.5** | **17.1** | **16.6** |

Source: Congressional Budget Office, *The Long-Term Budget Outlook* (December 2003), p. 7.

Note: Primary spending is the sum of spending for defense, Social Security, Medicare and Medicaid, and other spending (except interest).

a. Minor differences in simulated gross domestic product (GDP) result in small differences among paths in Social Security spending as a share of GDP.

b. Other spending is lower in 2030 and 2050 under the high spending path than under the intermediate path because this category includes premiums paid by Medicare enrollees, which are treated as negative outlays, and those premiums are larger under the high path's assumption of 2.5 percent excess cost growth.

the interaction of demographic shifts, rising health care costs, and policies aimed at improving the well-being of retirees, the disabled, and the chronically ill.

As you know, the growth in spending for health programs is far from certain. Rising health care costs are boosting spending to a greater degree than can be explained by the growth of enrollment and general inflation alone. Since 1970, those factors, as well as policy changes, have caused annual costs per Medicare enrollee to rise about 3.0 percent faster than per capita gross domestic product (GDP), on average—a difference referred to as "excess cost growth." If that growth remained high—at 2.5 percent, for example—the federal government's spending for Medicare and for its share of the joint federal/state Medicaid

program would together exceed 21 percent of GDP by 2050 (compared with 4.1 percent in 2004), and total spending would be about 33 percent of GDP. CBO's intermediate projection (presented in Table 1) is based on the Medicare trustees' assumption that excess cost growth declines to 1 percent above the growth of per capita GDP. However, even at that rate, the federal costs of Medicare and Medicaid would climb to more than 11 percent of GDP in 2050.

Other potential demands, such as Social Security, defense spending, homeland security, and environmental cleanup, may also claim a substantial share of society's resources. The cost of meeting those demands is uncertain, but there is little doubt that over the long term, the federal budget faces growing pressures that are likely to absorb an increasing share of the U.S. economy.

## Contingent Government Spending

In addition, the federal government faces significant fiscal exposure arising from its insurance and guarantee programs and other commitments that are contingent on adverse events that may or may not occur. In many cases, the federal government's commitment to cover at least a portion of a potential loss is unambiguous. In other cases, the extent to which the government would be required to cover a loss is, itself, uncertain. In virtually all cases, the exact amount that the government will be required to pay in any particular year is unpredictable.

Federal credit programs already budget the expected costs of those programs, but the government remains liable for all unexpected losses as well. The fiscal exposure resulting from guaranteed loan programs is exemplified by the mortgage insurance provided by the Federal Housing Administration (FHA) and the Department of Veterans Affairs (VA). The FHA programs provide mortgage insurance to encourage lenders to make credit available to expand home ownership. The VA program provides partial guarantees of residential mortgage loans issued to eligible veterans, reservists, and service members. Together, the face value of the outstanding loans that were fully or partially guaranteed by those programs totaled over $700 billion at the end of 2004.

The federal government also guarantees loans made to students and their parents for higher education. At the end of 2004, the outstanding volume of guaranteed student loans totaled about $250 billion. Smaller programs provide guarantees for a wide range of loans, including guarantees for certain export activities, small business loans, agricultural credit, business and industry loans, and rural housing.[1] At the end of 2004, the outstanding loans made by those programs had a face value totaling about $200 billion.

1. See Department of the Treasury, *2004 Financial Report of the United States Government*, p. 111, available at www.fms.treas.gov/fr/; and Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees* (August 2004).

Through other programs, the federal government provides direct loans for various purposes. The largest such program is the student loan program run by the Department of Education. At the end of 2004, about $100 billion in direct student loans were outstanding. Other large direct loan programs provide lending for rural utilities and housing, various foreign loans, loans to support export activities, and loans to finance spectrum auction sales.[2]

A number of insurance programs also expose the federal government to risk. The Federal Deposit Insurance Corporation insures deposits in more than 9,000 commercial banks and savings associations. The Terrorism Risk Insurance Act, enacted in 2002, created a temporary federal reinsurance program to absorb most of the risk of financial loss from acts of foreign terrorism in the United States.[3] Other programs provide insurance for losses from floods and crop failures caused by bad weather or other natural disasters.

Much attention has been focused recently on the financial condition of the pension plans insured by the Pension Benefit Guaranty Corporation (PBGC). PBGC insures projected benefits in 31,000 defined-benefit plans. For years, the corporation's receipts exceeded its benefit payments, and the budget reflected that positive cash flow instead of the underlying liability. Recently, though, PBGC estimated that insured pension plans were underfunded by more than $600 billion. So the ultimate cost of pension insurance to the government could be significantly larger than PBGC's current deficit of less than $25 billion.[4]

A number of other potentially large contingent liabilities are suggested by recent experience rather than by policies under current law. Although no statutory requirement exists for most federal relief following natural disasters (such as large earthquakes and hurricanes), homeowners, small businesses, and state and local governments frequently anticipate and receive substantial federal assistance for uninsured losses following those events.

The United States also supports multilateral financial institutions (MFIs)—such as the International Monetary Fund and the World Bank's International Development Association and its International Bank for Reconstruction and Development—that lend money to other member countries. Those borrowers have often gone into arrears and sometimes defaulted on their debts to other lenders. They have restructured their debts and, at times, asked for debt forgiveness. Some of the features of world financial markets that have protected MFIs from losses, such as the presumed seniority of their claims over other lenders', may not protect them in the

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2. Department of the Treasury, *2004 Financial Report of the United States Government*, p. 111.

3. Congressional Budget Office, *Federal Terrorism Reinsurance: An Update* (January 2005).

4. Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Performance and Accountability Report, Fiscal Year 2004* (November 15, 2004). PBGC estimated that, as of September 30, 2004, total underfunding in single-employer plans exceeded $450 billion and in multiemployer plans exceeded $150 billion.

future. The creditor countries in the G-7 are debating forgiving the debts that poor countries owe to the MFIs, and U.S. taxpayers may bear some portion of those costs.[5]

In addition, in financial markets, the government-sponsored enterprises (GSEs) Fannie Mae, Freddie Mac, and the Federal Home Loan Banks are perceived to be backed by an implied federal guarantee of their debt and other financial obligations. That implicit guarantee is communicated to investors through a number of provisions of law that create a perception that the GSEs have enhanced credit quality as a result of their affiliation with the government. Those provisions include a line of credit at the U.S. Treasury and exemption from state and local income taxes. In addition, although federally chartered and federally insured banks face a limit on the amounts that they can invest in other types of securities, that limit does not apply to the GSEs' securities. Taken together, those statutory privileges have been sufficient to overcome an explicit denial of federal backing that the GSEs include in their prospectuses. Assisted by the implied federal guarantee, those three companies have grown into some of the largest financial institutions in the world.

## The Economic Costs of Federal Spending

As a general rule, the best measure of the economic burden of a government program is its spending. Consider, for example, a discretionary program financed by annual appropriations. Spending by such a program diverts productive resources from private consumption or investment to government use. If the activity replaces private consumption with government consumption, the costs are felt in the present. If, however, the effect of government spending is to displace private investment, the cost is forgone growth in the capacity of the economy to produce—a loss that persists into the future. Federal financing of expenditures, either through taxes or borrowing, reduces the resources available in the private sector, and the people deprived of those resources bear the burden of government spending.

Resources are limited. The use of resources for one purpose necessarily denies them to others—a fact of life that is sometimes easy to forget. For example, much of the discussion about future spending for Social Security and Medicare has focused on whether revenues earmarked for those programs will be sufficient and whether their trust funds will become insolvent. Although those issues may be important, they should not distract from the more fundamental economic consideration: the resources expended on those programs must be financed either by taxes or by borrowing, which implies future taxes. Thus, that spending will be just as costly as any other federal spending.

5. For a preliminary analysis of the costs and budgetary treatment of MFIs, see the statement of Douglas Holtz-Eakin, Director, Congressional Budget Office, "The Costs and Budgetary Treatment of Multilateral Financial Institutions' Activities," before the Senate Committee on Banking, Housing, and Urban Affairs, May 19, 2004.

In economists' jargon, every dollar spent on a government program has an opportunity cost: that dollar is not available to be spent on something else. The cost, then, is whatever is forgone. When, as an individual consumer, I am deciding whether to buy an automobile, I am (at least implicitly) determining whether I would get more value using the money for that purpose than for any other. When, as elected representatives, Members are deciding whether to spend $100 million for a federal program, they are making a similar determination: is that the best use of taxpayers' money, given the possibility of other uses? Even though most such legislative decisions are not directly tied to decisions about taxes, the result is the same: unless other expenditures are reduced, current or future taxpayers will be required to give up the benefits from the use of those funds.

A distinction is sometimes drawn between the economic costs of government activities in which the government directly purchases goods and services, such as military procurement, and other government activities in which the government transfers purchasing power (money) to recipients, such as the Social Security program. In the first case, the government is causing taxpayers to have fewer resources at their disposal so that it can use those resources to purchase specific goods and services. In the second case, the government is reducing the resources available to taxpayers in general and is increasing the resources available to the program's beneficiaries but is not directly purchasing specific goods and services. Recipients can use the resources to buy whatever they want or save them for themselves or their heirs. In both cases, however, taxpayers are giving up control of resources. Whether their tax payments are then used by the government to purchase aircraft or by the recipients to purchase consumer goods or anything else does not affect the cost to the taxpayers.

Although I am stressing spending as a measure of economic cost, it is worthwhile to note an additional cost of public programs financed through tax revenues. The existence of taxes may change the behavior of the taxpayers in ways that reduce their well-being, a cost referred to as the excess burden of taxation. For example, a tax on wages may cause some people to work fewer hours or to retire earlier than they otherwise would have. A tax levied on a good or service will induce taxpayers to reduce consumption of the taxed item to avoid the tax. (Of course, in some cases, the tax is designed to reduce consumption, as with the taxes on alcohol and tobacco, because consumers may not fully cover the costs of their behavior.) Taxes that distort economic decisions thus have two costs: the amount collected and the loss to individuals from induced changes in behavior. The latter cost, however, is quite difficult to estimate, which suggests that focusing in the budget on the direct burden of government spending is the most valuable immediate objective.

## The Economic Costs of Federal Risk-Bearing

A particularly difficult and increasingly important issue is the treatment of risky activities like providing loans, guarantees, and insurance. Earlier in my testimony, I noted a wide range of economic transactions in which the federal government

either directly or indirectly takes on risk associated with bad outcomes. For example, the Federal Deposit Insurance Corporation bears most of the cost of the risk of bank failures.

Such arrangements in effect shift some or all of the risk to the federal government and, through the government, to taxpayers as a group. The risk of a bank failing is not reduced by the government bearing the cost. Indeed, the existence of the insurance may, itself, provide an incentive for organizations or individuals to engage in riskier activities than they would have without that insurance. Even though the government may be in a better position to take on a particular risk, the government's assumption of a risk does not eliminate its cost.

Risk is costly, whether it is borne by an individual or a company. Most of us prefer a sure thing over an uncertain outcome. Individuals are willing to pay to avoid risk. They buy insurance policies because they do not want to bear all of the risk of their house burning down. Companies purchase many kinds of financial instruments to protect themselves from incurring the full cost of losses that would result from circumstances over which they have no control. In each case, the reduction of risk is considered to be something of value, and the individual or the company is willing to pay for it.

The mirror image of this aversion to risk is that individuals typically demand compensation in order to bear risk. In financial markets, a measure of the extent to which individuals dislike risk is the so-called equity premium—the difference between the expected return on riskier equities (stocks) and the expected return on safer short-term Treasury securities. Depending on the time period examined, that premium has ranged from 3 percent to 7 percent in the United States. It arises from the fact that investors are willing to take on the additional risk of stock investments only because the expected return is higher than that from bonds. An investor choosing between a risky stock portfolio and low-risk bonds would almost certainly choose the bonds if the expected return was the same on both. In that case, the price of bonds would be bid up relative to the price of stocks, until investors had no preference between the two—that is, until the additional expected yield on the stocks exactly offset the costs to investors of the additional risk. Consequently, when returns are measured net of the costs of risk, private securities carry the same returns as government securities.

When the federal government assumes a risk—as it does, for example, when it guarantees a loan—the risk of default has been transferred from the lender to the government (and through the government to taxpayers), but the risk has not been eliminated. Instead, the government, rather than the lender, bears the risk. Market behavior, such as that which gives rise to the equity premium, may be used to assess the budgetary value assigned to assuming the costs of risk.

Direct loans and guarantees by the federal government constitute an area of budgeting where the Congress addressed accounting shortcomings through the Federal Credit Reform Act of 1990. Prior to that law, both direct loans and guar-

antees were treated on a cash basis in the budget. For direct loans, cash flows in any single year consist of outlays for new loans and repayments for some outstanding ones. The net cash flow in any single year, as an amalgam of the amounts of cash in and out, does not provide any meaningful indication of a credit program's long-term costs, although it is useful for the purpose of assessing federal borrowing needs. The cost of new loan programs is especially overstated on that basis because nearly all the cash flows are out in the early years. For guarantees, single-year cash flows are a mix of fee collections, payments for defaults, and inflows from recoveries. Before credit reform, the misstatement of costs for new guarantee programs was especially perverse because cash flows in the early years often were dominated by the inflow of guarantee fees, with few outlays for defaults.

Under the Federal Credit Reform Act, the cost of a direct loan or loan guarantee is the net present value of all expected cash flows over the life of the loan, recognized when the loan is disbursed. Net present value is calculated by discounting cash flows with interest rates on Treasury securities of the same maturity. A much-needed step toward getting the economic cost of credit programs in the budget, credit reform follows the principle of recognizing budgetary impacts at the time loans and guarantees are extended. Grants, direct loans, and guaranteed loans now can be compared on a more level playing field. In my judgment, the budget information now available to the Congress on the cost of credit programs is far superior to what existed before.

With the experience of more than a decade since the enactment of credit reform, however, it may be time to revisit the credit-reform model and its application. One shortcoming of the current approach is that it appears to understate the economic cost of federal credit programs because the discounting of expected cash flows at the government's risk-free borrowing rate ignores certain costs of risk. Private investors, by contrast, require compensation to induce them to bear risks that cannot be eliminated by diversification—for example, market risk. The compensation to investors for market risk comes in the form of an expected return that is higher than the rate on government debt that is used to value loans and guarantees under the credit-reform model.

Turning to other areas involving the federal treatment of risk, I would point out that the current budgetary accounting for federal insurance programs, such as deposit and pension insurance, still falls far short of the objective of assigning full economic costs to those activities. Currently, the costs of those activities are reported on a cash basis, which does not reflect the multiyear nature of the commitments. One result is that the programs report negative spending in most years, suggesting that they provide net income to the government, when in fact they represent a potentially large contingent liability. Consequently, alternative approaches may be needed to recognize the economic costs of insurance programs in the budget, perhaps building on the principles underpinning credit reform.

## Principles to Guide Budgetary Recognition of Costs

Policymakers constantly weigh the costs and benefits of proposed and existing legislation. Just as markets work best in allocating resources to their highest-valued uses when prices reflect the true costs of goods and services, the Congress is best served when Members have the most comprehensive and accurate information about the costs of legislation. Moreover, because federal budgeting affects the allocation of resources between private and public uses as well as among public uses, the relevant cost is the highest-valued alternative to all other uses, private as well as public. All alternatives can be better compared when budgetary costs reflect economic costs.

Spending is a good measure of cost because it will have to be financed, at least eventually, by taxes. Thus, a guiding budgetary principle should be to recognize in the budget the amount of taxes that will be needed to finance a commitment. Furthermore, at the point when the commitment has been made, its cost should be recognized in the budget, even if the spending will not occur immediately. I acknowledge that it is sometimes difficult to distinguish exactly when a commitment to spend has been made and how durable that commitment may be.

Although a one-time appropriation may reflect a commitment with clear timing and duration, relatively few spending decisions are that straightforward. In fact, many programs that are nominally controlled by annual appropriations are ongoing functions—such as defense, transportation, and education—that the federal government could reasonably be expected to continue, and baseline budget projections reflect that expectation.

The difficulty of determining the timing of commitments is illustrated by a federal policy to provide financial assistance to low-income students enrolled in higher education. That policy might be regarded as a commitment to spend for students who are now eligible and for students who become eligible in the future. However, because the commitment is not contractual for future applicants, the Congress might change the law defining eligibility or substitute a different form of assistance. Clearly, the current program cannot be regarded as irrevocable; therefore, the present value of future assistance should not be recorded in the budget.

Indeed, for social insurance programs, it seems fair to say that although the commitments are clear in current law and are so reflected in baseline budget projections, the government has not firmly committed to paying the current level of benefits to all future generations. In other cases, such as loan guarantees and insurance, the government's commitment to spend may be contractual and firm, but the value of the dollar payments may be uncertain and difficult to estimate.

I suggest that the principle of recognizing the costs of commitments in the budget when they are incurred implies that the mere expectation of future spending is not sufficient to warrant recognition in the budget. The government's obligation in the future must be firm to justify including the costs for it in the budget today. However, I also suggest that the principle of being timely in recognizing costs in the

budget never excuses an estimated cost of zero just because the amount is not yet certain.

## Improving Budgetary Presentations to Reflect Economic Costs

In order to discuss alternative budgetary presentations, it is important to consider the role of the budget alongside other forms of federal financial reporting, most importantly the *U.S. Financial Report* published annually by the Treasury. Taken together, the financial report and the budget provide a wide array of information to policymakers.[6]

The role of the financial report is to summarize the government's current assets and liabilities and changes in those amounts during the past year. The report uses accrual accounting to summarize current and future cash flows into a single presentation of the government's net financial position. In contrast, the role of the budget is to facilitate decisionmaking by the Congress about how to allocate resources now and in the future. Unlike the financial report, the budget displays economic costs in two ways: it shows the allocation of *spending authority*—upfront permission to commit the government to future expenditures—and it tracks the actual *outlays* of funds from the Treasury.

The budget seeks to present future demands on federal resources under current law, as well as proposed changes to those demands. However, current budget presentations may not be sufficiently comprehensive in two important ways: they may not present information over a suitably long time period for certain policy decisions or include all commitments for which the federal government may incur economic costs.

The current budgetary horizon, generally either five or 10 years, is adequate for most policy decisions of government. However, with the pending retirement of baby boomers and the corresponding demands that will arise in the Social Security and Medicare programs, it is not surprising that many federal policy issues today involve much longer time frames.

Federal outlays are expected to grow significantly over the next several decades. To facilitate understanding of the financial consequences of that growth, long-term budget projections extend the budget's horizon for 50 to 100 years to depict the timing and trends that are inherent in current and proposed policies. CBO has also, where feasible, provided information regarding the source and size of uncertainties that surround those projections. The scale, timing, and uncertainty about current-law spending are useful inputs to any proposal to reform policies.

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6. A provision in the Concurrent Resolution on the Budget for Fiscal Year 2004 directed CBO, in consultation with the Senate Budget Committee, to prepare a report on the costs of federal programs. See Congressional Budget Office, *Measures of the U.S. Government's Fiscal Position Under Current Law* (August 2004).

Some observers have suggested presenting long-term information in the budget through summary measures of future spending flows, which are similar in many ways to the accrual measures used in the financial report. Such summary present-value measures can display—in a single number—certain expected long-term obligations. As of 2004, for example, the present value of the future benefits provided under Medicare until 2050 was roughly $20 trillion (on the basis of the assumptions used for the intermediate spending path in Table 1).[7] The financial report presents such estimates as supplementary information to reflect the potential long-term costs of currently scheduled social insurance benefits.

For decisionmaking, such measures can be very useful to rank the size of specific budgetary imbalances. However, because such measures summarize cash flow budget projections, they are subject to the same uncertainties as those presentations but also include additional uncertainty in the choice of discount rates that are used to produce one summary number. Such measures can also be difficult to interpret, because they often reach trillions of dollars but provide little information about the resources that will be available to pay costs as they occur.

In particular, the term "unfunded liabilities" has been the source of considerable confusion, leading some people to misconstrue the economic significance of trust funds and trust fund balances. The term may also suggest that certain liabilities are funded when, in fact, the real source of all funding is the government's ability to levy taxes.

Cash flow presentations present important information about the expected *timing* of financial events, which can be critical information for policy development. Many policies could be adopted that would reduce a summary measure of imbalance to zero in 50 or 100 years but leave an imbalance in subsequent years, particularly for the fast-growing health programs. Furthermore, potential policy fixes could be "gamed" by allowing expenditures up front with promises of larger cuts later.

The second potential shortcoming of current budget presentations is the treatment of contingencies. The budget recognizes the losses from contingencies when the government makes cash payments to beneficiaries. For insurance programs, multiyear budget projections attempt to anticipate a "normal" amount of such spending. However, in any budget period, it is possible that no outlays will be made or that income from premiums will exceed outlays. The resulting net cash inflow could cause observers to underestimate the government's exposure to loss—especially when the commitments involve costs associated with infrequent events.

In general, however, presentations of contingencies are incomplete in the federal budget and the financial report. For example, neither presents the federal government's expected responses to natural disasters (for example, earthquakes or floods)—yet federal supplemental emergency appropriations in response to

7. If excess cost growth is 2.5 percent, the figure rises to roughly $30 trillion.

natural disasters averaged more than $5 billion annually in the 1990s, and insurance markets and the public at large clearly expect such support to continue in the future. Nor does current reporting include the financial risks associated with government-sponsored enterprises or with government support of multilateral financial institutions.

Another cause of incomplete reporting on contingent commitments involves the manner in which the federal government now estimates the magnitude of potential claims. Those uncertain future costs appear to be underestimated because no cost is currently recognized for bearing the risk associated with uncertainty.[8]

8. See Congressional Budget Office, *Estimating the Value of Subsidies for Federal Loans and Loan Guarantees.*

Senator ALLARD. With that, I want to go ahead and call the committee closed.

[Whereupon, at 11:12 a.m., the committee was adjourned.]

# MEDICARE AND MEDICAID: RISING HEALTH CARE COSTS AND THE IMPACT ON FUTURE GENERATIONS

**THURSDAY, FEBRUARY 17, 2005**

U.S. SENATE,
COMMITTEE ON THE BUDGET,
*Washington, DC.*

The committee met, pursuant to notice, at 10 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Bunning, Ensign, Alexander, Conrad, Nelson, Stabenow, and Corzine.

Staff present: Scott B. Gudes, Majority Staff Director; and Don Dempsey and Dave Fisher.

Staff present: Mary Ann Naylor, Staff Director; and Sue Nelson.

## OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will start the hearing. We very much appreciate our witnesses joining us today.

A lot of the testimony that we have heard so far in this committee about the issue of the fiscal solvency of our Nation and specifically our Government and how we address responsible management of our fiscal house has been tied to the question of health care. I think there is no debate any longer about the fact that health care is the single biggest driver of Federal expenditures for the foreseeable future. It is probably also the biggest driver of the costs of day-to-day life in this country as we head into the future.

We have this aging generation, the baby-boom generation, which a lot of discussion has been focused on, and their needs in health care are going to increase exponentially as they head into the retirement years.

We had Comptroller Walker testify that there is a huge amount of unfunded liability in this country, about $43 trillion worth over the actuarial life of the various programs, of which the majority, about $27 trillion, is directly tied to health care costs.

The President has begun to address this issue both from a policy standpoint and from a budget standpoint, and in the budget he has made proposals in the area of trying to address Medicaid costs. And this committee will hopefully also address those issues.

But the big elephant in the room is Medicare and how we address the cost of Medicare and make health care available for seniors but also make it affordable for the young people who are working who have to pay the costs of the HI insurance.

So we have asked the panel to join us today. The panel is made up of experts in the area of health care who have had a lot of experience with the Social Security funds and the management of the health care/Medicare system. And we look forward to getting their input on ideas that we as a Government could address to try to start to manage the health care issue not only from a standpoint of cost because cost is really the tail. The dog is delivery of service and how you make it—continue to deliver quality but make it affordable.

And so we are joined by Dr. Thomas Saving, who is a professor of economics at Texas A&M. He is a member of the Board of Directors of the Social Security and Medicare Trust Funds and has been instrumental in the development and the use of the infinite horizon to detail the financial difficulties facing Social Security and Medicare.

We are also joined by Dr. Jeffrey Brown, who is assistant professor of finance at the University of Illinois on the Urbana-Champaign campus. Dr. Brown is assistant professor, as I mentioned, and he was a senior economist at the White House from 2001 to 2002, and I believe he has just been nominated to be a member of the Board of Trustees of the Social Security Trust Fund.

And Lois Quam, who is the CEO of Ovations, a business unit of the UnitedHealth Group which provides health services to Americans age 50 and older, including insurance products for AARP and care options including Medicare supplement and hospital health insurance and plans, prescription drugs and discount programs.

So it is a high-quality panel who I know are going to have a lot of good ideas to give us as we move forward in the budget and move forward in addressing this very critical issue of public policy.

Senator Conrad.

## OPENING STATEMENT OF RANKING MEMBER KENT CONRAD

Senator CONRAD. Thank you, Mr. Chairman. We missed you yesterday.

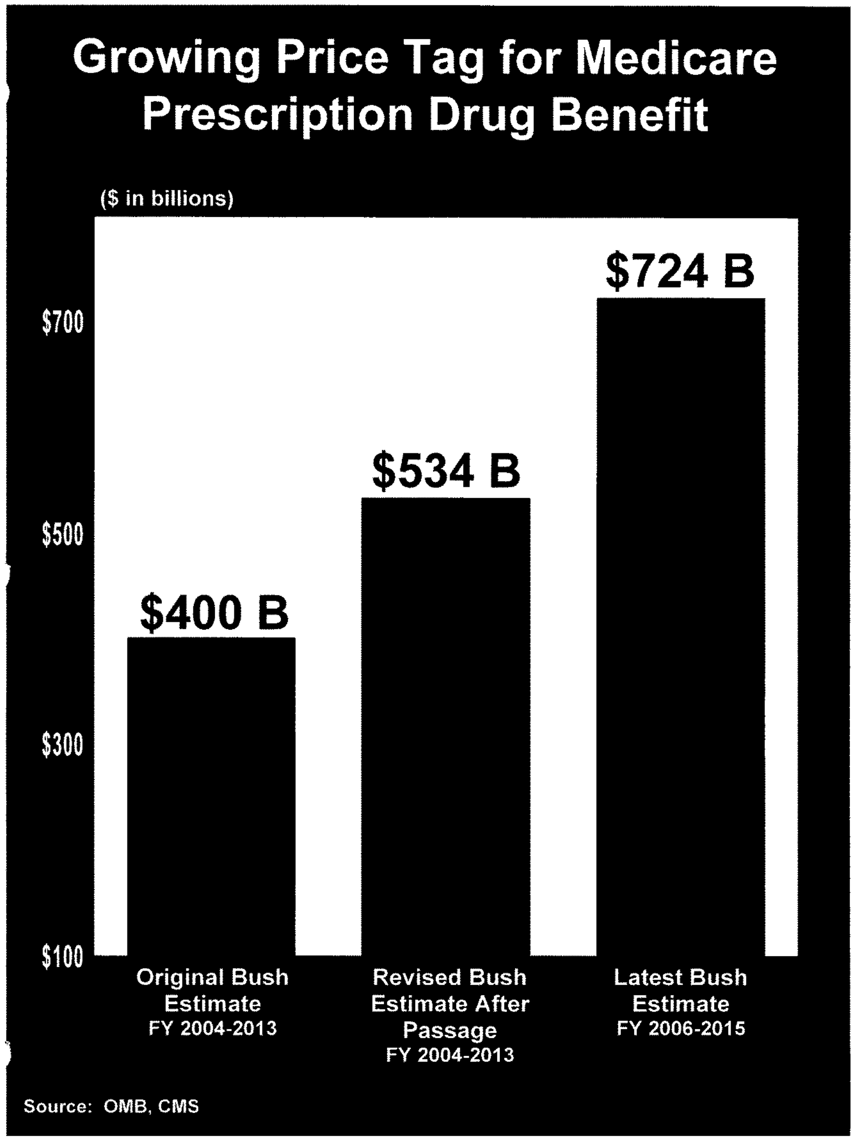
Chairman GREGG. Sorry I was not able to be here.

Senator CONRAD. Senator Allard carried on in exemplary fashion, and I thought we had really an outstanding session yesterday. I think we had more ideas on how we might save money for Medicare yesterday than almost any session that I have been at. And it just tells me that if we had an opportunity for everybody to come forward with their best ideas, we might make real progress.

Yesterday, the testimony from the Director of the Congressional Budget office noted that in 2050, if nothing changes, and if we see the same trend lines hold, over 20 percent of the gross domestic product of the United States will be spent on just two items: Medicare and Medicaid. It is pretty stunning when you just extrapolate out from where we are now and look at the increases that are projected as the baby-boomers retire, more people are eligible for these programs, and health care costs continue to explode.

Just to put it in some context, Federal spending since World War II has been at about 20 percent of gross domestic product. So to have just two items consume 21 percent of gross domestic product obviously is an unsustainable course.

Let me put up this chart. In recent days, we have learned that the prescription drug benefit that was passed in 2003 is exploding in cost. When we passed it, we were told it would cost $400 billion. That estimate was later revised for the same period to be $534 billion. And now we are being told that for a different 10-year period it is going to cost $724 billion. So we have exploding costs with the most recent legislation that was passed for the Medicare program.


Growing Price Tag for Medicare Prescription Drug Benefit
($ in billions)
$700
$500
$300
$100
$400 B
$534 B
$724 B
Original Bush Estimate FY 2004-2013
Revised Bush Estimate After Passage FY 2004-2013
Latest Bush Estimate FY 2006-2015
Source: OMB, CMS

Yesterday, Mr. Chairman, I said I really do think it is time for all of us to come forward with our best ideas on how to save money in Medicare. I have put up five ideas that I think could help us make a difference:

## Five Steps to Lower Medicare Costs

- Better coordinate care – focus on 6 percent of beneficiaries who use roughly 51 percent of Medicare resources
- Eliminate $10 billion slush fund provided to HHS Secretary to sweeten pot for private health care providers
- Cut $30-$50 billion provided to private health care providers over and above what traditional Medicare pays
- Allow HHS Secretary to negotiate lower drug prices for Medicare beneficiaries, like Veterans Administration
- Allow reimportation of prescription drugs

Better coordinate care. Yesterday, I indicated 5 percent of the population uses 50 percent of the money. The most recent statistic is 6 percent use 51 percent of the money. I think we ought to focus like a laser on that population, and we will hear more about that in today's testimony.

I think we ought to consider eliminating the $10 billion slush fund provided to the Health and Human Services Secretary to sweeten the pot for private plans.

I think we ought to cut the $30 to $50 billion of expenditure that is the amount private plans are costing over and above traditional Medicare.

I think we ought to allow the Health and Human Services Secretary to negotiate lower drug prices, just as the Veterans Administration is able to do very successfully.

And I think we ought to allow the reimportation of prescription drugs. In Canada, my State borders Canada—drug prices are dramatically lower. There is no reason not to reimport those drugs manufactured in the United States that have gone to Canada, and have much lower prices. Let's bring them back and at least at some point be importing something that helps the economy.

Those are ideas, Mr. Chairman, that I would like to put some focus on in the hearing today. I hope others will stress other ideas, because clearly we are on a course that is not sustainable.

I thank the Chair.

Chairman GREGG. Can I ask the Senator a question?

Senator CONRAD. Absolutely.

Chairman GREGG. Because I am intrigued by his five proposals. I think it is constructive that he is willing to bring forward specific proposals. Can you explain the slush fund?

Senator CONRAD. You know, in the Medicare prescription drug bill——

Chairman GREGG. Oh, this is Medicare? That is the money that was set aside in the Medicare fund. OK. I understand. You are talking about the drug fund then?

Senator CONRAD. Yes, right.

Chairman GREGG. I thought it was the overall Medicare.

Senator CONRAD. No. And, you know, this was set aside to allow the Secretary of Health and Human Services to sweeten the pot for certain private plans.

Chairman GREGG. Right, to keep their plans.

Senator CONRAD. No, that is another element of the legislation, to allow private sector businesses to keep their existing plans. I am talking now about the money that was given to the Secretary, money at his discretion to use to sweeten the pot for other private sector plans because they were concerned about regional differences.

Chairman GREGG. Is that a 10-year number?

Senator CONRAD. Yes, and the $30 to $50 billion is a 10-year number.

Chairman GREGG. Thank you.

Well, we will start with you, Dr. Saving. We would like to hear your thoughts, and then we will go down the line.

**STATEMENT OF THOMAS R. SAVING, DIRECTOR, PRIVATE ENTERPRISE RESEARCH CENTER**

Mr. SAVING. Mr. Chairman, thank you for having me here, and I am really going to concentrate my discussion here on the long-run costs of Medicare, and we can deal with questions later on.

Chairman GREGG. Can you pull the microphone a little closer to you and make sure it is on?

Mr. SAVING. A little closer? All right. And maybe get the height of it adjusted to my lower center of gravity.

Today, Medicare is the second largest entitlement, program behind Social Security. In 2004, Medicare accounted for 13 percent of the Federal budget, 2.6 percent of gross domestic product and required general revenue transfers equal to 10.7 percent of Federal income tax revenues. The program provides health care and insurance for the retired and disabled population, the same population served by Social Security. The 2003 Medicare Modernization Act made Medicare's health insurance coverage more comprehensive, with the addition of a prescription drug benefit. It did other things also to general Medicare, but that is beside the point here. Making the coverage more comprehensive has also made the program more costly. By 2024, total Medicare spending is expected to exceed Social Security spending, and the differential will continue to escalate thereafter.

Here I want to discuss several ways to address the current and future status of Medicare as it pertains to the Federal budget. So I am going to concentrate a lot on the Federal budget. As a trustee of the Social Security and Medicare Trust Funds, I will highlight a few of the measures I believe shed light on Medicare's financial position.

Before getting to the estimates of the total cost of Medicare, I want to review a couple of the characteristics of Medicare that will cause it to become larger than Social Security in just 20 years and become 50 percent larger by the middle of this century. And while both Social Security and Medicare share the same demographics, the similarity ends there.

Social Security's revenue and expenses, without consideration of the demographic issues, rise at roughly the same pace as the Nation's gross domestic product. Its future deficits are the result of two—or three things, actually: the baby-boom generation's retirement, falling fertility rates, and increasing life span.

Medicare faces these same demographic issues, plus the fact that the population's demand for health care, something that you alluded to already, Mr. Chairman, is growing faster than the Nation's gross domestic product and has been for a century, so that nothing has changed there. Since 1960, per capita health care expenditures have grown 3 percentage points faster than per capita gross domestic product. But Medicare Part A Hospital Insurance tax revenues rise only as fast as gross domestic product. This means that even if there were no demographic issues at all, Medicare would face future deficits. Other components of the Medicare program face a similar fiscal situation. Supplementary Medical Insurance, SMI, comprised of Parts B and D, prescription drugs, are financed through premium payments. They provide approximately 25 percent of the program. The rest of it, 75 percent, are general

revenue transfers. The premium payments are expected to rise about 25 percent of expenditures, so they are going to grow as fast as expenditures and, thus, they are actually going to grow faster than gross domestic product. But because 75 percent of these expenditures are financed by general revenue transfers, an ever larger proportion of general Government revenue will be required to fund SMI, that is, Parts B and D of Medicare.

Because the revenue for Part A is not linked to GDP growth, the day will come when premium payments for SMI—that is, both prescription drugs and what used to be physician things—will actually exceed the tax revenues for Part A. In 2003, the tax revenues were more than 5 times total Medicare premiums. In 2005, when the prescription drug benefit becomes fully operational, the HI tax revenues will still be 3.5 times premium revenues. But by 2055, the premium revenues will exceed the HI tax revenues.

Now, in producing the Trustees Report estimates of future expenditures, we assume that by 2029 Medicare expenditure growth will have fallen from its current level of approximately 2 percentage points faster than per capita gross domestic product to 1 percentage point faster. And then when we end the 75-year horizon, we gradually let the growth of health care fall to exactly the same as the growth of gross domestic product. Both of these assumptions may be conservative as there appears to be little evidence that health care expenditures will not continue to grow at more than our ultimate assumed rate of 1 percentage point above per capita gross domestic product.

Now, Medicare's financial status can be summarized in two ways: one of them in terms of the present value of future unfunded liabilities, which people are familiar with, often the 75-year horizon, sometimes a longer horizon; and, second, in the past of future budget transfer required to cover future shortfalls. And I think that may be more appropriate in regard to this committee, but I am going to address both of those.

The first of these represents how much the system owes, and the second represents how much the general tax revenue must be tapped to meet these obligations. Medicare is fundamentally a generation transfer system; current taxpayers pay for the benefits of current retirees. And the fundamental economics of such a system is that the debt that we owe the current generation is going to have to be paid by the future generation. And I want to separate that debt, the way we do it in the Trustees Report, into the three principal programs of Medicare. Part A, Hospital Insurance, the debt owed to the current generation, that is, everybody who is working now and currently retired, if we pay them the benefits that are in the bill at the moment and we only charge them the tax rate, which is the HI tax rate, the unfunded liability for the current generation is $14.2 trillion.

Now, in a system that worked, that is, in a system that was in equilibrium, the next generation would pay—would have a surplus because they would enter the system—they will start working tomorrow. They will pay taxes for 45 years before they ever collect any benefits, so they should contribute something to paying off this debt? Rather than contributing anything, what are they going to do? They are actually going to generate $7.8 trillion more in debt.

So that the total unfunded liability for just the Hospital Insurance part of Medicare is $22.1 trillion.

Now let's move to Medicare Part B, which, along with the prescription drug benefit, Part D, of course, comprises Supplementary medical Insurance. Unlike Part A, which is meant to be financed with HI taxes, Part B is set up to be financed with general revenue transfers of 75 percent. And we know that that is going to make for a rising cost. So the difference between the premium income that we expect to accrue over the whole period and expenditures for the current generation is $8.8 trillion.

Now, the next generation is going to cost us another $14.4 trillion, so the unfunded liability, the present value of the unfunded liability for Medicare Part B is $23.3 trillion, and this comes right out of last year's 2004 Trustees Report.

Now, let's consider the newest addition to Medicare, Part D, prescription drug benefits. Again, this operates exactly the way SMI does. It has premium payments, which are roughly going to cover 25 percent of expenditures. The unfunded liability for Part D for the current generation is $6.2 trillion. The next generation, rather than contributing anything to paying that off, is going to add another $10.3 trillion to it. So the total unfunded Part D liability is $16.6 trillion.

All three of these together, we owe the current generation $29.2 trillion. Now, David Walker talked about $27 trillion, which is the 75-year unfunded liability, and this is the current generation's unfunded liability. The two numbers are similar, but they have a different meaning. The future generation is going to add $32.5 trillion to this obligation. The total Medicare unfunded liability as it now stands is $61.6 trillion.

I am going to put it in perspective for you. Assuming that Federal income tax revenues were to remain at the 50-year average of 10.9 percent, roughly, of gross domestic product—now, they were lower this year; they were only like 8.7 percent because we are still coming out of the recession. But if they were to do that, the present value of all future Federal income tax revenues is $99.3 trillion. The unfunded liability here is $61.6 trillion. It is 62 percent of all future Federal income tax revenues.

If you pass legislation today binding on all future Congresses that set aside 62 percent of all Federal income tax revenues, starting tomorrow to eternity, that is what it would take to cover this liability. You would have to give up almost two-thirds of all Federal income tax revenues. This year you spent 10 percent on Medicare, so that means roughly 50 percent additional of all Federal income tax revenues would have to be set aside from now to eternity to cover the debt. So the funds have—that means that—and what I would really like to say, again, bear in mind that you cannot just spend the money and send us some bonds, send CMS some bonds that we will later on cash. I mean, this means you really would invest the 62 percent of Federal income tax revenues in real resources in the economy because that is what would in the future generate the revenue and the resources and the output that it would take to provide these benefits that we are promising.

As a final note—and this comes back to the 75-year horizon, the numbers that David Walker talked about—that number is $27.7

trillion, but that is only the 75-year number. And even erasing that would take for the next 75 years your setting aside 43 percent of all Federal income tax revenues. And then at the end of the 75 years, you would have these huge debts that you would still have to pay off. So these are very significant numbers.

Now, another way of understanding these future funding problems is just look at the cash-flows. They can be denominated in a number of different ways. I like to denominate them in terms of Federal income tax revenues, again, because I think that is meaningful. I am not convinced that the way we do it in the Trustees Report where we denominate these things in terms of gross domestic product is very meaningful to most people. They do not understand what gross domestic product is, and it is clear from a budget perspective that Federal income tax revenues are a clear budget item, income, and what you want to know is how much of that income do we have to transfer to these programs.

They may seem like a manageable amount. We are going to show a deficit—the Hospital Insurance portion showed for the first time in many years a deficit last year, in 2004, and that is going to grow at an accelerating pace over the next 25 years. Part D, prescription drug benefit, will begin in earnest next year and will rapidly grow in its requirements on the budget. The transfers required to pay the current law benefits given current law taxes and premiums will grow from their current level to almost 19 percent of Federal income taxes in 2015. Now, remember, they were 10 percent this last year, in 2004. They are going to double by 2015. They are going to triple by 2025 to a third of all Federal income tax revenues. And they are going to require over 90 percent of Federal income tax revenues by 2075. It is hard to imagine transfers of this magnitude being made, but the only real alternative is for individual members of society to ultimately provide more of the funding for their own retirement health care. How we are going to do that and, second, somehow make markets so that people care about what it costs—and one of our fundamental problems is they do not.

As I pointed out above, the trustees have adopted the assumption that health care costs per capita will grow at a rate equal to GDP per capita growth plus 1 percentage point. And that implies alone that health care expenditures will rise from the current level of 15 percent of gross domestic product to 38 percent by 2075. But, actually, of course, they have been historically growing much more rapidly than that. And if they were to grow plus 1.5 or 2 percentage points, then they are going to account for 55 or 79 percent of GDP, and they are going to account for huge proportions, if we are paying for them the way we are now. Federal income tax rates would have to be way over 50, 60 percent, rather than 11 percent of gross domestic product.

Now, numerous factors contribute to health care growing faster than the rest of consumption. Regardless of the cause, it seems reforms are inevitable given that 45 percent of all health care spending today is paid for by taxpayers through Federal, State, and local government funds. Now, that same 45 percent sounds like a number that we have to report to you, but that is State and local. I will get to that number right now.

Beginning with the 2005 Medicare Trustees Report, as you know, the Medicare Modernization Act requires the Board of Trustees to test whether the difference between program outlays and dedicated financing sources, consisting of payroll taxes, share of income taxes, and premium payments, reach 45 percent of total Medicare expenditures. If this critical level is expected to be attained within 7 years of the projection, then we have to say there is excess general funding and we have to let the White House know that, and they have to come to Congress with something. In the 2004 Trustees Report, we reported that the critical difference is expected to reach the 45-percent level in 2012. That is just 1 year short of the 7-year requirement. If our 2005 Trustees Report for which we do not have the final numbers at this time—is consistent with that, that means that this year when we issue the report, we would be issuing an excess general funding warning to the executive branch.

To conclude, since I am past my time here, as my fellow trustee John Palmer and I have noted several years in the summary of the combined Medicare and Social Security reports, Medicare's financing problems occur sooner than Social Security's, and the solutions to its problems are more difficult. The more difficult part is important. This past year Part A, Hospital Insurance, spending was in excess of tax revenues. The others will be increasing general revenue transfers with each passing year. The pace of this increase will accelerate when the full Part D prescription drug benefit takes effect. The demands Medicare places on the rest of the Federal budget will force Congress to consider some difficult choices of who should bear the burden of retirement health care spending. As the debate over Social Security has highlighted the generational consequence of financing elderly entitlements, the generational burden represented by Medicare amplifies the need for serious consideration of reform.

Thank you.

[The prepared statement of Mr. Saving follows:]

**Medicare Now and in the Future**

Thomas R. Saving
Director, Private Enterprise Research Center, Texas A&M University
Public Trustee, Federal Hospital Insurance and Federal Supplementary Medical Insurance Trust Funds

Testimony before the Senate Budget Committee
February 17, 2005

Today Medicare is America's second largest entitlement program, behind Social Security. In 2004 it accounted for 13 percent of the Federal budget, 2.6 percent of GDP and required general revenue transfers equal to 10.7 percent of federal income taxes. The program provides health care insurance for the retired and disabled population, the same population served by Social Security. The 2003 Medicare Modernization Act made Medicare's health insurance coverage more comprehensive with the addition of a prescription drug benefit. Making the coverage more comprehensive has also made the program more costly. By 2024 Medicare spending is expected to exceed Social Security spending and the differential will continue to escalate thereafter. Here I discuss several ways to assess the current and future status of Medicare as it pertains to the Federal budget. As a Trustee of the Social Security and Medicare Trust Funds I will highlight a few of the measures I believe provide Congress and the Public a complete picture of Medicare's financial situation.

**The Future Cost of Medicare**

Before getting to estimates of the total cost of Medicare, let me review the characteristics of Medicare that will result in a program that is currently smaller than Social Security, becoming larger than Social Security is just 20 years and that will be 50

percent larger than Social Security by the middle of this century. While both Social Security and Medicare share the same demographics, the similarity ends there.

Social Security's revenue and expenses, without the consideration of the coming demographic issues, are approximately proportional to the nation's Gross Domestic Product (GDP), so its future deficits are the result of a combination of the baby boom generation's retirement, falling fertility rates and increasing life-spans.

Medicare, on the other hand, faces these same demographic issues, plus the fact that the population's demand for health care is growing faster than the nation's GDP. For example, since 1960, per-capita health care expenditures have grown three percentage points faster than per-capita GDP. Essentially, Medicare Part A, Hospital Insurance (HI), tax revenues rise only as fast as GDP, which implies that even if there were no demographic issues, the faster than per-capita GDP growth of HI expenditures would rapidly outpace HI revenues. Supplementary Medical Insurance (SMI), comprised of Medicare Part B and Part D, prescription drugs, are financed through premium payments, approximately 25%, and general revenue transfers, approximately 75%. Since the premium payments are expected to remain about 25% of expenditures, they will grow as fast as expenditures and thus faster than GDP. In fact, in 2003, HI tax revenues were more than five times total Medicare premium income and in 2006, after the prescription drug benefit becomes fully operational, HI tax revenues will be 3.5 times SMI premium income, but by 2055 SMI premium income will exceed HI tax revenues.

In producing the Trustees Report estimates of future Medicare expenditures we assume that by 2029, Medicare expenditure growth will have fallen from its current level of approximately two percentage points faster than per-capita GDP to one percentage

point faster than per-capita GDP. Further, for the estimates beyond the 75-year horizon, we assume that Medicare expenditure growth will gradually fall until after 25 years it is equal to per-capita GDP growth, so that after 100 years the share of health care in GDP will remain constant for the indefinite future. Both of these assumptions are conservative as there appears to be no evidence that health care expenditures will not continue to grow at more than our ultimate assumed one percentage point above per-capita GDP.

**Table 1**
**Real Per-capital Growth in National Health Expenditures (NHE)**
**Versus Gross Domestic Product (GDP)**
**%**

| Period | NHE | GDP | NHE-GDP |
|---|---|---|---|
| 1945 to 2002 | 4.2 | 1.5 | 2.6 |
| 1960 to 2002 | 4.5 | 1.5 | 3.0 |
| 1970 to 2002 | 4.0 | 1.8 | 2.2 |
| 1980 to 2002 | 4.4 | 2.0 | 2.4 |
| 1990 to 2002 | 3.7 | 1.9 | 1.8 |

Source: 2004 Review of Assumptions and Methods of the Medicare Trustees' Financial Projections.

Medicare's financial status can be summarized in two broad ways: in terms of the present value of future unfunded liabilities and in the path of future budget transfers required to cover the funding shortfalls. Medicare is fundamentally a generation transfer system in that current taxpayers pay for the benefits of current beneficiaries, primarily retirees. The fundamental economics of a generation transfer system is that unless current law is changed in some way, the debt owed to the current generation, all those in the system now (meaning both workers and retirees), must be paid for by future generations, those who begin work tomorrow and after.

Let me separate the debt owed to the current generation by the three principal programs that comprise Medicare. The Part A, Hospital Insurance, or traditional Medicare, debt owed to the current generation is, from the 2004 Trustees Report, \$14.2 trillion. How much under current law will future generations, the new entrants to the system beginning with those who start work tomorrow, contribute toward paying this \$14.2 trillion debt? Actually, they will not contribute anything. If projected benefits are paid and only scheduled taxes and premiums are collected, future generations will actually add \$7.8 trillion to the unfunded liability of Medicare Part A. Thus, the total unfunded liability of Medicare Part A is \$22.1 trillion.[1]

**Table 2**
**Composition of Medicare's Unfunded Obligations**
**(Trillions 2004\$)**

| Group or Category | Hospital Insurance Part A | Supplementary Medical Insurance Part B | Part D | Combined |
|---|---|---|---|---|
| 75-Year Open Group | 8.2 | 11.4 | 8.1 | 27.7 |
| Current participants | 14.2 | 8.8 | 6.2 | 29.2 |
| Future participants | 7.8 | 14.4 | 10.3 | 32.5 |
| Current and future participants | 22.1 | 23.2 | 16.6 | 61.9 |
| Trust Fund offset | 0.3 | 0.0 | 0.0 | 0.3 |
| Infinite horizon | 21.8 | 23.2 | 16.6 | 61.6 |

Source: Tables II.B12, II.C17, II.C23 2004 Medicare Trustees Report.

Now consider Medicare Part B, which along with prescription drug benefits, Part D, comprises Supplementary Medical Insurance (SMI). Unlike Medicare Part A, which is

[1] The total is not equal to the sum of the two components due to rounding.

meant to be financed wholly with HI taxes, the payroll tax plus Medicare's share of the income taxation of Social Security benefits, Medicare Part B is set up as an insurance program with participants paying a premium. However, unlike private health insurance where premiums cover cost, the SMI Part B premium is set to cover only 25 percent of Part B costs with the remaining funding coming from the federal budget. The Medicare Part B obligation owed to the current generation, the difference between premium income and expenditures, is $8.8 trillion. If the formula for premiums remains unchanged and projected benefits are paid, future generations will add $14.4 trillion to this debt. Thus, the total unfunded liability of Medicare Part B is $23.3 trillion.

Finally let us consider the newest addition to Medicare, Medicare Part D, or prescription drug benefits. This part of Medicare is an insurance program in the same sense that Part B is, in that participants are only expected to pay premiums that cover about 25 percent of the total cost.[2] The Medicare Part D obligation owed to the current generation, the difference between premium income and forecast expenditures, is $6.2 trillion. If the formula for premiums remains unchanged and projected benefits are paid, future generations will add $10.3 trillion to this debt. Thus, the total unfunded liability of Medicare Part D is $16.6 trillion.

Taking all three parts of Medicare together we owe the current generation a total of $29.2 trillion and future generations will add another $32.5 trillion to this obligation. Thus, the total Medicare debt is a staggering $61.6 trillion. Let me put this number in perspective for you. Assuming that federal income tax revenues remain at the 50 year average of 10.89 percent of the nation's gross domestic product, the present value of all future federal income tax revenues from now to eternity is $99.3 trillion so that the

[2] This includes premiums paid by Medicaid for eligible Medicare beneficiaries.

Medicare debt of $61.6 trillion is 62 percent of all future federal income tax receipts. Thus, if Congress passed legislation today, binding on all future Congresses, setting aside 62 percent of all federal income tax revenues from now to eternity, you could just pay for promised Medicare benefits. Bear in mind that this setting aside of 62 percent of federal income tax revenues cannot be in the form of treasury bonds sent over to CMS but must be in the form of real investment in the economy. That means that the funds must come from some combination of increased federal income taxes, reduced federal expenditures and increased federal borrowing.

As a final note, the unfunded liability is often calculated using the traditional 75-year horizon. This horizon fails to measure what happens after the end of the horizon and thus ignores whether or the system improves or gets worse at the close of the period. The total 75-year unfunded liability for Medicare is $27.7 trillion, close to the debt owed the current generation of $29.2 trillion, although the two numbers are not directly comparable. Even erasing this 75-year debt would require setting aside 43 percent of all federal income tax revenues for the next 75 years.

**Table 3**
**Composition of Medicare's Unfunded Obligations**
**(% of Federal Income Taxes)**

| Group or Category | Hospital Insurance Part A | Supplementary Medical Insurance Part B | Part D | Combined |
|---|---|---|---|---|
| Current participants | 14.3 | 8.9 | 6.2 | 29.4 |
| Future participants | 7.9 | 14.5 | 10.4 | 32.7 |
| Current and future participants | 22.3 | 23.4 | 16.7 | 62.3 |
| Trust Fund offset | 0.3 | 0.0 | 0.0 | 0.3 |
| Infinite horizon | 22.0 | 23.4 | 16.7 | 62.0 |

Source: Tables II.B12, II.C17, II.C23 2004 Medicare Trustees Report. Federal Income taxes are estimated to be 10.89% of GDP which is its 50 year average share.

Another approach to understanding the future funding problems facing Medicare is to review the annual cash flows. These annual funding requirements can be denominated in several ways: as nominal dollars, constant dollars, as a share of Gross Domestic Product, or as I prefer, as a share of federal income taxes. The first three measures may be understood by the small cadre who prepare the Trustees Report and some of the more ardent analysts, but I have found that if I speak in terms of the share of federal income taxes, everyone can understand the implications for future funding. For example, in 2004, Medicare spending net of premium payments and dedicated tax revenues required general revenue funding equal to 10.7 percent of total federal income tax revenues.[3]

This may seem like a manageable amount, but two things are worth noting. First, Medicare Part A, the Hospital Insurance portion, will show a deficit in 2004 after several years of surplus and this deficit will grow at an accelerating pace over the next 25 years. Part D, the prescription drug benefit will begin next year, but will rapidly grow in its requirement on the budget. The transfers required to pay current law benefits given current law taxes and premiums will grow from their current level to almost 19 percent of Federal income taxes in 2015, to over 32 percent in 2025, and will require over 90 percent of projected federal income tax revenues by 2075![4] Clearly it is hard to imagine transfers of this magnitude being made.

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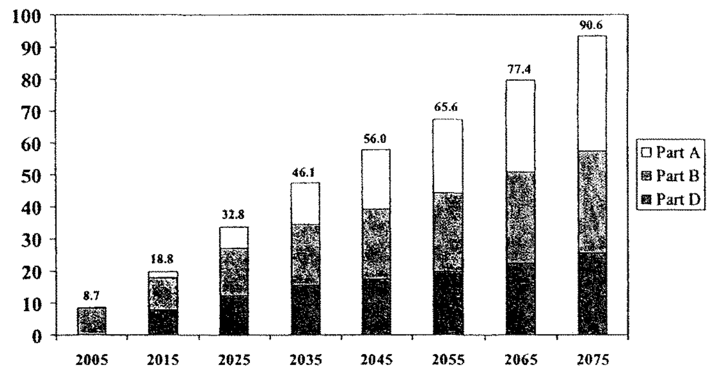
[3] Federal income taxes, individual and corporate, were equal to 8.6 percent of GDP in 2004.

[4] The projected transfers as a percentage of Federal income taxes assume that income taxes will equal 10.89 percent of GDP in future years. These percentages can also be thought of as the increase in Federal income taxes, above their 50 year average share of GDP that would be necessary to meet Medicare's funding requirements.

# Medicare Funding Requirements as a Percentage of Federal Income Taxes




Source: 2004 Medicare Trustees Report, and author's estimates. Federal Income Taxes are estimated to be 10.89% of GDP which is the 50 year average.

Individual members of society must ultimately provide some of the funding for their own retirement health care. In addition, health care markets in general must be reformed in a way that users of the system care about cost. As I pointed out above, the Trustees have adopted the assumption that health care costs per-capita will grow at a rate equal to GDP per-capita growth plus 1 percentage point. This implies that health care expenditures will rise from 15 percent of GDP today to 38 percent of GDP by 2075. However, if spending were to rise at a rate equal to per-capita GDP plus 1.5 percentage points or GDP plus 2 percentage points, then health care would account for 55 or 79 percent of GDP, respectively, by 2075.[5] Numerous factors contribute to health care growing faster than the rest of consumption. Regardless of the cause, it seems reforms are

[5] Estimates are from *Review of Assumptions and Methods of the Medicare Trustees' Financial Projections*, Technical Review Panel on the Medicare Trustees Reports, December 2000.

inevitable given that 45 percent of all health care spending today is paid for by taxpayers through federal, state, and local government funds.

Beginning with the 2005 Medicare Trustees Report, the Medicare Modernization Act requires the Board of Trustees to test whether the difference between program outlays and dedicated financing sources, consisting of HI payroll taxes, the HI share of income taxes on Social Security benefits, Part D State transfers, and beneficiary premiums, exceeds 45 percent of to total Medicare expenditures. If this critical level is expected to be attained within seven years of the projection, a determination of "excess general funding" is triggered. In the 2004 Trustees Report we reported that the critical difference is expected to reach the 45 percent level in 2012, just one year short of the seven year requirement. If our 2004 forecasts remain on track, we can expect that the trigger will be reached in this year's Trustees Report. At this point, however, it would be premature for me to comment on this since the final numbers for the 2005 Trustees Report are not yet in place.

As my fellow Public Trustee, John Palmer and I have noted for several years in the summary of the combined Medicare and Social Security Trustees reports, Medicare's financing problems occur sooner than Social Security's and the solutions to its problems more difficult. This past year Medicare Part A, Hospital Insurance, spending was in excess of its tax revenues, and Supplementary Medical Insurance, Medicare Parts B and D will require increasing general revenue transfers with each passing year. The pace of this increase takes a step forward with when the full Part D prescription drug benefit takes effect next year. The demands Medicare places on the rest of the Federal budget will force Congress to consider some difficult choices as to who should bear the burden

of retirement health care spending. As the debate over Social Security has highlighted the generational consequence of financing elderly entitlements, the generational burden represented by Medicare amplifies the need for serious consideration of reform.

Chairman GREGG. I would like to say thank you, Doctor, but to tell you the truth, you just made me sort of sick.

[Laughter.]

Chairman GREGG. Thank you. Those were startling and sobering numbers, to say the least.

Dr. Brown?

**STATEMENT OF JEFFREY R. BROWN, PH.D., ASSISTANT PROFESSOR OF FINANCE, UNIVERSITY OF ILLINOIS AT URBANA-CHAMPAIGN**

Mr. BROWN. Chairman Gregg, Ranking Member Conrad, and members of the committee, thank you for the opportunity to speak before you today about the implications of an aging population for the Medicaid program.

As you know, in just 3 years the leading edge of the baby-boom generation is going to start claiming Social Security benefits. In just 6 years, they are going to start claiming Medicare. In the years to follow, millions of them will find that, due to declining health, they are in need of long-term care services, including nursing homes. As a result of the substantial costs of paying for long-term care, many of them will end up relying on Medicaid to finance their own care after their own financial resources have been exhausted.

While my written testimony focuses primarily on Medicaid, I do want to take just a moment to put Medicaid's cost growth into this broader context which Dr. Saving has just told us about, which is the context of overall growth in entitlement spending.

Today, spending on Social Security, Medicare, and Medicaid combined is about 8.5 percent of GDP. Just 25 years from now, about the time that I am looking to retire, these three programs alone will be close to 16 percent of GDP. The farther into the future that one looks, the larger these programs become.

As Senator Conrad already mentioned, total spending today by the entire Federal Government is about 20 percent of the economy. Looking ahead about 75 years, absent significant change to the structure of these programs, Social Security, Medicare, and Medicaid alone will account for 25 percent of this Nation's output.

Now, this is obviously before we have set aside a single penny to support national defense, homeland security, environmental protection, or educating our children. It is also before any State and local government has raised money to support programs at their level. And then, of course, one must also keep in mind the obvious fact that future generations are still going to need money to live on, to start careers, to buy homes, to educate their children, and save for their own retirement.

So to sustain these entitlement programs strictly on a pay-as-you-go basis in the future decades will require substantial increases in tax burdens. And, unfortunately, large tax increases can in turn basically serve as a drag on future economic growth, which can, therefore, exacerbate the problem.

So it is clear, as all of you know, that the time to begin thinking about the long-term prospects for these programs is now because the sooner that we begin to face these issues, the more choices we have available to us.

I would like to specifically turn to Medicaid now. As you know, Medicaid is a very important source of health care financing for about 46 million individuals today. This includes children, pregnant women, individuals with disabilities or who are blind, as well as the elderly. And obviously this program plays a very important role in the lives of its beneficiaries, providing health care to people who otherwise might not be able to receive the care they need.

Unfortunately, the financial burden of Medicaid, which is shared by both the Federal and the State governments, is large and it is growing. This year, for example, it is expected that the Federal Government will spend approximately $190 billion on Medicaid. If you include both Federal and State spending on Medicaid, it is well north of $300 billion.

As large as this level of spending is, it is the trend in spending that is perhaps even more noteworthy. Over the last 10 years, at a time when the economy grew by about 60 percent, Medicaid expenditures more than doubled. CBO and OMB projections are both that Medicaid expenditures are going to continue to grow faster than the economy for the foreseeable future, and the role that aging of the population plays in this is relatively straightforward. It is attributable to three basic facts: first, America is growing older; second, older Americans spend disproportionately more on health care, particularly long-term care services such as nursing homes; and, third, because Medicaid today is the single largest source of payment for nursing home and other long-term care expenditures in the U.S. It currently covers about 40 percent of nursing home expenditures. And, therefore, Medicaid expenditures are anticipated to rise.

Under reasonable assumptions, by the time today's kindergartners reach age 65, Medicaid spending at both the Federal and State level will consume about $5 out of every $100 produced by the economy.

Now, to better understand these trends, I want to focus just a bit on the interplay between long-term care and Medicaid in the United States. As I already mentioned, Medicaid covers a wide range of beneficiaries, but from the perspective of a budget and the perspective of the economic impact, not all Medicaid beneficiaries are created equal. What I mean by that is roughly one-half of Medicaid beneficiaries today are children, and yet children only account for about $1 out of every $8 of Medicaid spending.

In contrast, the aged currently represent just a little over 10 percent of Medicaid enrollees, but account for over one-quarter of all expenditures. And long-term care is a major reason for this.

Medicare, which Dr. Saving referred to, pays the lion's share of acute medical spending for the elderly, but it has very limited coverage of long-term care. In addition, there is very little private insurance coverage in the U.S. for long-term care. Last year, it was estimated that only about 4 percent of total long-term care expenditures were covered by private insurance. This is in very sharp contrast to the market for acute care. And also in contrast is the fact that the Medicaid program, as I mentioned, is the single largest source of financing for long-term care. It is about 40 percent of nursing homes, 35 percent of all long-term care.

It is also worth noting, by the way, that this leaves about one-third of long-term care expenditures currently paid for out of pocket by individuals.

But in regards to Medicaid, this suggests that, absent significant policy changes in the way we finance long-term care, rising long-term care expenditures in the aging population will certainly lead to rapidly rising Medicaid outlays in the years to come.

In my written testimony, I go into more depth about some of the other factors that influence this process, in particular, changes in life expectancy, changes in the disability rates among the elderly, as well as factors like changes in family structure that influence the degree to which there are informal substitutes available for formal care. While these issues are complex and, therefore, make it difficult to pin down a very precise estimate of future costs, nearly every plausible scenario suggests that Medicaid expenditures are going to continue to grow faster than the economy in the coming decades.

Looking into the future, one interesting question is to what extent some of the future costs of paying for long-term care can essentially be off-loaded onto the private sector through encouraging private long-term care insurance markets. I discuss this issue in more depth in my written testimony and would be happy to take questions. But, in particular, I focus on the fact that among the many possible explanations for why the private market is so small, the Medicaid program itself turns out to be one that is quite relevant. Specifically, Medicaid serves as a disincentive for people to purchase private insurance policies for reasons that I am happy to go into during the questions and answers. And as a result, it is unlikely, absent some sort of significant reform to the way we think about Medicaid, that private insurance markets are going to save the day for us.

So just to conclude, let me just say that we all know that Americans are living longer. This is great news for each of us as individuals. But we have to recognize that the existing financial structure of the entitlement programs in the U.S., particularly those that are serving the elderly, are going to place an ever increasing burden on future generations.

If we continue to try to finance all of these programs on a pay-as-you-go basis, we are not going to have many good alternatives. We can either impose an ever increasing tax burden on future generations; we can start scaling back benefits for the elderly; or we can basically reduce or even eliminate all non-entitlement spending. The best and possibly the only alternative to those scenarios are to try to find ways today to increase national savings. By increasing national savings, essentially what we are doing is reducing our current consumption in order to set aside resources to invest in the economy, to grow the economy, and hopefully provide the resources for the future from which to pay these rising costs.

I would be happy to take questions. Thank you for the opportunity to speak to you.

[The prepared statement of Mr. Brown follows:]

# Budgetary Implications of an Aging Population: The Case of Long-Run Medicaid Expenditures

Testimony before the United States Senate
Committee on the Budget

by

Jeffrey R. Brown, Ph.D.
University of Illinois at Urbana-Champaign
brownjr@uiuc.edu

February 17, 2005

Testimony of Jeffrey R. Brown

Chairman Gregg, Ranking Member Conrad, and members of the Committee. I am Jeffrey Brown, Assistant Professor of Finance at the University of Illinois at Urbana-Champaign.[1] I thank you for the opportunity to appear before you today to discuss the long-run implications of an aging population for the Medicaid program.

**I. Overview of the Budgetary Challenges of an Aging Population**

In recent weeks, there has been a vigorous public discussion about the implications of an aging population on the future of one of the United States' largest entitlement programs – Social Security. As a result of a declining ratio of workers to retirees, Social Security's pay-as-you-go financial structure is fiscally unsustainable and in need of real reform.

As important as the debate over Social Security is, however, it is equally important to remember that Social Security is not the only large entitlement program whose finances are adversely affected by population aging. Medi*care*, the public health insurance program for the elderly, and Medi*caid*, the means-tested program for the poor, are also facing rapidly rising costs, thanks in part to an aging population. While I plan to focus primarily on Medi*caid* in my testimony today, I do want to take just a moment to place Medicaid's cost growth into this larger context.

In just three years, the leading edge of the baby boom generation will begin claiming Social Security benefits. In just ~~five~~ six years they will begin claiming Medicare. In the years to follow, millions of them will find that, due to declining health, they need long-term care services, including nursing homes. As a result of the substantial costs of paying for long-term care, many of them will end up relying on Medicaid to finance their care after their own financial resources have been exhausted.

The rising costs of these programs clearly indicate reason for concern. Under 2004 Trustees' intermediate assumptions and CBO's long-term Medicaid estimates, spending for Social Security, Medicare, and Medicaid combined will grow from 8.5 percent of GDP today, to 15.6 percent of GDP by 2030 – just 25 years from now.[2]

Let's be clear about what this means. By the time today's 40 year-old reaches age 65, our nation will be spending $1 out of every $6.40 produced by the entire economy, just to support these three entitlement programs.

The farther into the future one looks, the larger these programs grow relative to the economy. Today, total spending by the *entire* federal government accounts for about 20

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[1] I am also a Faculty Research Fellow with the National Bureau of Economic Research (NBER), and Associate Director of the NBER Center for Retirement Research. During 2001 and 2002, I was Senior Economist with the President's Council of Economic Advisers.

[2] A substantial part of the short-term cost growth is due to the start-up of prescription drug coverage under Medicare.

percent of GDP.[3] *Absent significant reform of our entitlement programs, in just 75 years, Social Security, Medicare, and Medicaid alone are projected to consume 25 percent of GDP.* This means that one-quarter of the nation's total output will be spent on these three programs alone.

This is before we have set aside a single penny to support national defense, homeland security, environmental protection, education for our children, or any number of other national priorities. Nor does it include rising expenditures by state and local governments. Furthermore, that is just the consumption that is publicly financed, i.e., that which is to be paid out of taxes on future generations. One must also keep in mind the obvious fact that the workers of tomorrow – who are our children today – will still need money to live on as they start careers, buy homes, raise families and save for their own retirement.

To sustain these programs on a pay-as-you-go basis in future decades would require substantial increases in tax burdens. Unfortunately, large tax increases can in turn serve as a drag on future economic growth.

Thus, the time to begin thinking about the long-term prospects for all of these programs is now. As with any financial problem, the earlier one starts to address them, the more choices there are available.

**II. An Overview of Medicaid Expenditure Growth**

Medicaid today is an important source of health care financing for approximately 46 million individuals,[4] who become entitled to benefits by being part of an eligible group, including:

- Pregnant women
- Children and teenagers
- Aged individuals
- Individuals who are blind or disabled

This program plays an extremely important role in the lives of its beneficiaries, providing access to health care for segments of the population that are economically vulnerable, and who otherwise might not receive the health care they need.

However, the financial burden of Medicaid, which is shared by the Federal and state governments, is very large, and growing at a rapid rate.

In 2005, for example, it is expected that the Federal government will spend nearly $190 billion on Medicaid, while total federal plus state spending will be on the order of $325 billion, or 2.6 percent of GDP.[5]

[3] Budget for Fiscal Year 2006, Historical Tables, Table 1.2, page 24.
[4] Remarks by Secretary of Health and Human Services on Medicaid, February 1, 2005, States News Service.
[5] Estimates based on Office of Management and Budget's FY 2006 Budget, "Analytical Perspectives."

As large as this level of spending is, the *trend* in spending is even more noteworthy. From 1995 through 2004, federal spending on Medicaid nearly doubled at a time when GDP rose by less than 60 percent.[6] The OMB predicts that over the next five years, Medicaid expenditures will grow at approximately a 7 percent annual rate, which is significantly faster than inflation or GDP growth. As a result, Medicaid will continue to grow as a share of the economy and as a share of the federal budget.

When thinking about future trends in Medicaid cost growth, it is important to distinguish between different causes. For example, changes in Medicaid rules that relax or restrict Medicaid eligibility requirements can lead to one-time changes in Medicaid spending that do not necessarily change the trend in cost growth. Similarly, cyclical increases in Medicaid spending, such as those that might be driven by temporary increases in the number Medicaid beneficiaries during periods of economic downturn, are not indicative of long-term trends. Some sources of increased spending, however, are more systemic, such as those due to an aging of the population.

The focus of my testimony today is on *long-term* trends in Medicaid costs. In particular, I want to focus on how an aging population will likely influence future Medicaid program costs.

**III. Population Aging and Medicaid Costs**

To set the stage, I would like to begin by highlighting three basic facts that, together, indicate why it is important to think about the future of Medicaid expenditures:

1. First, as already indicated, America's population is growing older. Thanks to dramatic declines in mortality at all ages over the past century, the share of the U.S. population over age 65 has grown from under 5 percent in 1900 to approximately 12.5 percent today. It is expected that this trend will continue, and that by the year 2050, over 21 percent of the population will be over age 65.

2. Elderly Americans account for a highly disproportionate share of national health care spending. This is particularly true of certain types of expenditures, a perfect example being long-term care services, such as nursing homes.

3. The Medicaid program is the largest single source of financing for long-term care in America today, covering nearly 40 percent of nursing home expenditures and 35 percent of total long-term care expenditures, according to recent CBO estimates.

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[6] Federal Medicaid spending rose from \$89 billion in 1995 to \$176.2 billion in 2004 (Budget for Fiscal Year 2006, Historical Tables, Table 8.5). Nominal GDP in 1995 was \$7.4 trillion (Economic Report of the President), while nominal GDP in 2004 was \$11.73 trillion (OMB 2005).

Therefore, absent policy or other changes that significantly alter the way we pay for long-term care in the U.S., our nation will likely face rapidly growing fiscal pressure on the Medicaid program in the decades to come.

*To put it in the simplest possible terms, America is growing older. Older individuals use more long-term care. Medicaid is the leading payer of long-term care expenses. Therefore, Medicaid expenditures are expected to rise rapidly in the coming decades.*[7]

Estimates from the long-range model used by the OMB suggest that the federal share of Medicaid expenditures, as a fraction of GDP, will double over the next 60 years, rising from an estimated 1.5 percent in 2005, to 3.0 percent in 2065.[8] Importantly, this understates the impact of Medicaid expenditure growth because it focuses only on the federal share. Assuming that the federal share of Medicaid expenditures stays at just under 60 percent, this implies that by the time today's Kindergartners reach age 65, total Medicaid spending will consume over five dollars out of every one hundred dollars generated by the U.S. economy.

Having now made the broad point that population has the potential to increase Medicaid expenditures, it is important to examine the details of these relationships in more detail. To do so, I would like to proceed in four steps:

1. First, I will discuss the composition of overall Medicaid spending today, focusing on how that spending is divided at a broad level across elderly versus non-elderly populations.

2. Second, I will highlight the large and growing role that Medicaid plays in financing long-term care for the elderly.

3. Third, I will examine the trends in long-term care expenditure growth, and discuss what this likely means for growth of Medicaid spending.

4. Finally, I would like to say a few words about the role that Medicaid plays in the market for private insurance against long-term care expenditure risk.

*A. The Composition of Medicaid Spending*

As already noted, Medicaid serves a wide range of eligible groups, including pregnant women, children, individuals who are blind, persons with disabilities, and the elderly.

However, from the perspective of budgetary and economic impact, not all Medicaid beneficiaries are created equal.

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[7] As will be noted below, trends in disability rates, and other demographic changes, can also influence the growth in long-term care utilization, and thus Medicaid costs.
[8] Table 13-2 on page 209 of Budget for Fiscal Year 2006, "Analytical Perspectives."

For example, roughly half of persons served by the Medicaid program are children. However, children comprise only 16 percent of Medicaid expenditures.[9]

In contrast, the aged currently represent just over 10 percent of Medicaid enrollees, but account for over one quarter of all expenditures.

As we move into the future, it is reasonable to expect that a higher proportion of Medicaid recipients will be elderly individuals. Because this group spends disproportionately more on care than younger beneficiaries, this will place extra pressure on Medicaid finances.

When focusing on the elderly population, it is important to note that approximately two thirds of Medicaid expenditures on the aged is due to long-term care services, such as nursing homes and home health services. Put differently, roughly one out of every six dollars that the entire Medicaid program spends today is on long-term care services for the aged. This fraction is likely to increase in the future.

*B. How is Long-Term Care Financed Today?*

Because of the important effect that long-term care expenditures for the aged have on Medicaid financing, I want to turn now to a discussion of how long-term care is financed in the United States today. As a starting point, it is very important to know that the financing of long-term care differs markedly from that of acute care in this country.

Several features stand out:

1. First, Medi*care*, which pays the lion's share of acute medical care for the elderly, has extremely limited coverage of long-term care.

   While Medicare does cover 25 percent of total expenditures, this is primarily limited to short-term coverage. As recently explained by the CBO, "Medicare does not cover long-term care per se, but has become a de facto LTC financier through its coverage of care in skilled nursing facilities (following hospitalization) and its home health care benefit."[10]

2. Second, the share of long-term care expenditures paid by private insurance coverage is very small. Recent estimates by the CBO indicate that private insurance covered only 4 percent of total long-term care expenditures for the elderly in 2004.

3. Medi*caid* is the largest single source of financing for long-term care, covering approximately 35 percent of all expenditures. Because its payments are somewhat skewed toward coverage of institutional care, Medicaid pays nearly $2

[9] Estimates from Center for Medicare and Medicaid Services.
[10] CBO, "Financing Long-Term Care for the Elderly," April 2004.

out of every $5 spent on institutional long-term care of the elderly in the United States.

4. This leaves nearly one-third of long-term care expenditures to be paid for out of pocket by individuals. To put this in perspective, for the health sector as a whole, only 17 percent of expenditures are paid out of pocket.[11]

In short, the relation between Medicaid and long-term care is a two way street. Long-term care expenditures comprise a large fraction of total Medicaid spending. And Medicaid is responsible for a large fraction of total long-term care expenditures.

Thus, absent significant policy changes in the way we finance long-term care in the U.S., the rise in future Medicaid costs will be closely linked with growth in long-term care expenditures of our aging population.

*C. Projected Long-Term Care Expenditure Growth and Implications for Medicaid*

In my simplified analysis above, I focused on the primary demographic change, which is the fact that the number of elderly in the U.S. is growing rapidly. The Census Bureau estimates that the number of elderly individuals will double from 2000 to 2030. As a share of the population, the 65+ age group will rise from 1 in 8 today to over 1 in 5 by the middle of the 21st century.

Research indicates that, among those reaching age 65 in good health, the average age of first use of a nursing home is 83 for men and 84 for women. Therefore, it is particularly noteworthy that the share of the US population that is age 85 or older is expected to triple by mid-century (from 1.5% in 2000 to 5.2% in 2050).

It is clear that, all else equal, rising elderly populations will increase demand for long-term care, and thus increase fiscal pressures on Medicaid. However, not all else is equal. Forecasting future long-term care utilization is difficult due to several factors that work in offsetting directions, including:[12]

(i) One factor that could help to partially mitigate the rising dependency on formal long-term care is if, as individuals live longer, they also live healthier. That is, if we observe a declining prevalence of functional impairments, such as the ability to engage in activities of daily living, this could partially counteract the demographic pressure on long-term care costs. The evidence on functional impairment is mixed. There is substantial evidence that rates of impairment fell dramatically over the last century, and many analysts believe that recent rates of improvement will continue. However, there is also some

[11] National Center for Health Statistics, 2002. "Health, United States, 2002 with Chartbook on Trends in the Health of Americans." Hyattsville, MD.

[12] For a more in-depth discussion of the demographic trends affecting long-term care utilization, see the April 2004 CBO Report, "Financing Long-Term Care for the Elderly." My discussion of demographic trends draws substantially from that report.

evidence that impairment among people under age 65 may be increasing, which could lead to higher elderly impairment rates down the road.

(ii) Another factor that is difficult to forecast is the availability of informal substitutes for institutional care, such as that provided by family members. For example, many women provide informal care for their husbands, enabling them to stay at home rather than entering into a formalized care setting. As women live longer, on average, this may enable them to provide informal care for husbands at older ages.

(iii) As family sizes have fallen in recent decades, so too has the supply of potential adult child caregivers. When combined with increasing labor force participation rates of women, which has the effect of reducing the number of hours of care giving, the demand for long-term care services from the formal, paid sector, may rise.

These issues, and others, suggest that it is difficult to pin down a precise estimate of future long-term care expenditure growth. Nonetheless, most plausible scenarios suggest that expenditures for long-term care will likely outpace GDP growth over the next several decades. In other words, it is to be expected that Medicaid expenditures will continue to rise relative to the size of the economy.

*D. Medicaid and the Market for Private Long-Term Care Insurance*

As noted earlier, one of the major differences between acute health expenditures and long term care expenditures is the relative role of private and public insurance. In particular, private insurance covered only 4 percent of total long-term care expenditures in the U.S. in 2004.

Looking to the future, an important question is to what extent some of the future costs of paying for long-term care can be "off-loaded" onto the private sector through private long-term care insurance contracts. Indeed, several recent federal and local policy efforts have been focused on trying to stimulate this market.

There are many potential reasons that the private market in the U.S. is limited in size, including limitations on both the demand and supply side of the market. Given my focus on Medicaid today, however, it is instructive to consider the role of the existing Medicaid system.

In short, the Medicaid program appears to provide a disincentive for individuals to purchase private insurance policies against long-term care expenditures. This disincentive arises from the fact that, when a person buys a private contract, a large fraction of the benefits that they are purchasing are duplicative of what Medicaid would otherwise pay. In essence, Medicaid imposes a large implicit tax on the benefits of the private policy that renders its purchase unattractive for all but the highest wealth households.

This implicit tax arises for two reasons. First, a private policy protects a person's financial assets when they go into care. However, by protecting their assets, they also reduce the individual's ability to qualify for Medicaid coverage. Second, even in the event that the individual spends down enough to qualify for Medicaid benefits, Medicaid is structured as a secondary payer, which means that the private policy must still pay full benefits before Medicaid will pay.

As a result, absent significant structural changes in interactions between public and private insurance, there is strong reason to doubt the efficacy of public policy interventions designed to stimulate private coverage.

**IV. Concluding Remarks**

Americans are living longer than ever before, and that is good news for each of us as individuals. As a nation, however, we must recognize that an aging population will place growing fiscal pressures on all pay-as-you-go entitlement programs that are designed to provide financial assistance to older cohorts.

Having a larger share of our population over age 65 means that we should and will be spending a larger share of our GDP to support the consumption of the elderly.

However, we must also recognize that existing financial structure of key government programs that serve the elderly will place an ever-increasing tax burden on future generations. Social Security, Medicare, and Medicaid combined are projected to grow much faster than the economy. In just 75 years, it is estimated that these three programs will consume nearly one quarter of GDP.

If we continue to try to finance all of these programs on a pay-as-you-go basis, we will have no alternative but to impose an ever-larger tax burden on future generations, to scale back benefits, or to dramatically reduce all non-entitlement spending.

The best, and possibly only, alternative to trying to pay for these programs on a pay-as-you-go basis is to increase national saving. Increasing national saving, which requires that we reduce current consumption in order to invest for the future, can help to grow the economy as well as provide the resources from which to pay for the consumption of tomorrow's elderly.

Thank you for the opportunity to speak with you today.

Chairman GREGG. Thank you, Dr. Brown.
Ms. Quam.

**STATEMENT OF LOIS E. QUAM, CHIEF EXECUTIVE OFFICER, OVATIONS, A UNITEDHEALTH GROUP COMPANY**

Ms. QUAM. Chairman Gregg, Senator Conrad, and distinguished members of the committee, thank you for the opportunity to appear before you today. I am Lois Quam. I am chief executive of Ovations, which is the largest company providing services to the Medicare program. We are headquartered in Minnesota, and we are unique in that we participate in the Medicare program nationally, operating in both urban and rural areas, and we participate in the traditional fee-for-service program as well as Medicare Advantage and programs for the chronically ill.

The discontent about the growth and costs, which my fellow panel members have so eloquently spoken of, is igniting today's discussion and can and must be addressed. As the chairman indicated, it is not only an issue for Government, but it an issue for all of us.

Our discussions about solutions have followed predictable but somewhat frustrating patterns: calls for increased public subsidies, calls for cuts to public programs. As for the first, we cannot spend our way through this because cost increases outstrip our economic capacity. As for the second, cuts in this arena simply shift costs to others—families, providers, State taxpayers—rather than actually cutting or eliminating services.

So as business people, our job is to try to find practical and sustainable solutions. I wanted to offer the committee four ways that we may be able to do something else, and that is to powerfully shift to a strategy of not cutting our spending, but a strategy of using our current resources more successfully.

The first idea I would like to put before you is to improve services to those who are chronically ill. As Senator Conrad indicated in his opening remarks, people who are chronically ill use most of the Medicare budget and Medicaid budget. Five percent use slightly over half of those budgets. These are very sick people, and despite the immense amount of resources we put forward to care for them, they still suffer greatly.

We need to expand effective ways to care for them and invent new ways to improve their care and maintain their health because that also reduces our use of resources.

We, through our Evercare program, have been providing services in this area to the Federal Government since 1987, to many States, and to the British National Health Service since 2002. This sophisticated set of tools that we bring really comes down to a straightforward approach to do three things:

The first is we try to keep this very sick group of people as healthy as possible so they do not need to go to the hospital.

Second, we try to prevent those crises, like a broken hip or a case of the flu, that send them to the hospital for long stays.

And, third, when they become sick, we move heaven and earth to try to treat them where they live versus having to send them to the hospital.

Our results have been good. The independent Federal evaluation of Evercare found that we reduced hospitalizations by half while

achieving a 97-percent satisfaction rate among patients and their families, and a 20-percent reduction in the use of medication. In one Texas county, from 2000 to 2002, we saved $123 million through this approach.

The MMA provided some important expansions in this area in the special needs plans and in the chronic care improvement program, but there is great potential to do more, and I wanted to suggest three things:

The first is moving these chronic care programs from the edge of Medicare to its center, to focusing in this area.

The second, to focus on patients' burden of illness, not simply on discrete diagnoses.

And the third, to focus on the dual-eligible population, those people who have both Medicare and Medicaid coverage. They often get lost between those two programs, and there is an opportunity to improve their lives and save resources by focusing on them solely.

Second, I wanted to suggest that we look more diligently for ways to increase the productivity in American health care. If American health care productivity were simply on par with the rest of the American economy, we would not be having this discussion today. We would have the resources that we need to meet the challenges of Medicare and Medicaid. So how can productivity be improved? In our experience, it can be improved by improving the way that work and patient care is organized. We have seen dramatic increases in productivity by changing the way that we ask our work force and our caregivers to work.

Second, by using technologies to support better ways of working. We have invested over a billion and a half dollars in new technologies to make these changes in ways of working stick.

Third, we can use rapid learning models to get better results. In essence, learning quickly from things that don't work well. In Evercare, after every patient ends up in the hospital, we have a case conference where we don't say, "the flu is going through and it is inevitable that this is going to happen." We say, "what could we have done differently to prevent it from happening?" And what does that tell us about how we need to change the way we work? And then how can we instill that in our practice?

While productivity cannot be legislated, legislation can establish a framework for productivity: reward structures tied to preferred outcomes, incentives to invest in productivity tools like technology, and improved regulatory processes and standards.

I want to make clear that technology is not an end in and of itself but simply a tool. And, in fact, if the underlying ways of working are not improved, technology can, in fact, increase spending and productivity. It is a tool to institute and make stick better ways of working. Surely American health care, where so many of our best and brightest go to work, can be on par in productivity with the rest of our economy.

Third, we should look at ways of developing a national focus on evidence-based health insurance packages. This would encourage that best treatments are covered and that damaging or ineffective treatments are not covered. It would use science as its base. We need to invest in more research, and the MMA took an important step to do that. But lots of research is available which is not used.

And we would support an empowered, independent entity akin to the IOM that could develop evidence-based benefit packages that public purchasers and private purchasers such as ourselves could use. There may also be an interesting role for tax incentives here.

Finally, I would urge us all to look at ways to apply both the strengths of both the private sector and government to this important problem. So often the health care debate is counterproductive, focused on whether government or companies can do a better job. As chief executive of one of the nation's largest health care companies, I would be the first to acknowledge the importance and benefits of government. This debate does not need to be an either/or, but it can be effectively a debate about how to get the best out of both sectors. Each have strengths, each have weaknesses, which makes them complementary. Government does a great job of offering consistent programs nationally, providing security over time, concentrating resources on vulnerable populations, providing standard operating rules, to name a few.

Companies do a great job of adapting services locally, innovating rapidly, quickly deploying skilled staff, and inventing new ways of working, to name but a few.

I would urge a shift from the debate between the two to take on the real challenge of bringing about the best in each.

We have reached a state in health care where a new approach truly is required. Cost increases outstrip our ability to afford them, not only in the Federal budget but in State capitals and boardrooms and at dinner tables. It is time now to focus on a way to better use the existing resources that we have. There are ways to do that: improving care for the chronically ill, investing in productivity tools, translating research into practice, and using the practical and immense skills of both Government and companies to do that.

These efforts in a way have been at the periphery of our efforts in Medicare and Medicaid. They need to become its focus.

Thank you very much.

[The prepared statement of Ms. Quam follows:]

**Testimony of**
**Lois E. Quam**
**Chief Executive Officer**
**Ovations**
**A UnitedHealth Group Company**

**For**

**The United States Senate**
**Committee on Budget**

**Hearing on**
**"Medicare and Medicaid: Rising Healthcare Costs and the Impact on Future Generations"**

**Thursday, February 17, 2005**

**Introduction**

Thank you Chairman Gregg, Senator Conrad and other distinguished members of the Committee for the opportunity to testify before you at today's hearing on the cost challenges and opportunities facing the Medicare and Medicaid programs. I am Lois Quam, the Chief Executive Officer of Ovations, UnitedHealth Group's business that focuses on meeting the health care needs of the over-50 population – the very group of Americans who are the primary users of health care within both Medicare and Medicaid.

Ovations, and the other companies of UnitedHealth Group, have extensive experience providing health care services to the federal government, state governments and private payers in many types of competitive environments. As the largest health and well-being company in the United States, UnitedHealth Group's operating businesses provide a diverse and comprehensive array of services to approximately 55 million Americans. We provide services to over half of the nation's 100 largest companies.

UnitedHealth Group has a long-standing commitment to serving older Americans. Our participation in the Medicare and Medicaid programs is fundamental to our core mission – to support individuals, families, and communities to improve their health and well-being at all stages of life. We aim to facilitate broad and direct access to affordable, high quality health care.

My business, Ovations, is the largest provider of health care services to seniors in America. We offer a unique perspective on Medicare and Medicaid because we are a major provider of services through traditional fee for service, health plans, and demonstrations for the frailest beneficiaries that both these programs serve. Our commitment is therefore to the beneficiaries, the programs and the taxpayers who support them – rather than a specific product offering.

Ovations is dedicated to helping Americans in the second half of life address needs for preventive and acute health care services, deal with chronic conditions and respond to unique senior issues relating to overall well-being. We deliver supplemental health insurance products and services to 3.8 million AARP members living in all 50 states, the District of Columbia, Puerto Rico, Guam and the Virgin Islands. Through this program, we provide prescription drug coverage to the majority of all Medicare beneficiaries who receive drug coverage through Medigap plans.

Through Evercare, our business that serves the unique needs of frail elderly and chronically ill patients, we provide care and care coordination to disabled and chronically ill Medicare and Medicaid individuals living on their own, in community-based settings, and in nursing homes. We care for more than 70,000 people in 16 states (Arizona, Colorado, Connecticut, Florida, Georgia, Maryland, Massachusetts, Minnesota, New Mexico, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, Texas, and Wisconsin). Nearly 70 percent of our Evercare enrollees are dually eligible for Medicare and Medicaid. We also have over 330,000 Medicare beneficiaries enrolled in our various Medicare Advantage plans, including HMOs and PPOs.

**Traditional Motivations for -- and Approaches to -- Medicare/Medicaid Cost Challenges**

Not surprisingly, discontent about cost growth is igniting discussions like today's hearing about future directions for both Medicare and Medicaid. Frustration with health care affordability, predictability and financing are generally the issues that drive every major health care debate in this nation. The growth rates and cost projections that have been cited this morning are alarming and do -- and should -- demand attention.

Unfortunately, all too frequently our debates are centered on who is paying and how much rather than addressing the root causes of cost increases. Our solutions in this nation, whether that be in the Congress, State Capitol, boardroom, or dinner table, therefore, traditionally follow two predictable and generally frustrating paths: (1) increasing public subsidies; or (2) cutting public programs and cost-shifting to other payers.

As for the first path, we certainly cannot spend ourselves out of our dilemma, particularly now with the constraints posed by our federal deficit. Ironically, while policies in this arena initially moderate short-term health and financial problems, they can counterproductively delay action on needed delivery reforms.

As for the second traditional course of action, we must understand that across-the-board reimbursement cuts in Medicare's payment rates or growth caps in Medicaid will be almost inevitably poorly targeted and, as a consequence, create as much access and quality problems as they solve short-term cost challenges. Moreover, done carelessly, federal program cuts can, and frequently do, simply cost-shift burdens and risk to other payers (such as states, businesses and families), raising pressure to cut back on needed coverage or raise revenue (through higher premiums or state-based taxes).

Where possible, we need to shift away from these old prescriptions to the health care challenge. They tend to lead to unconstructive disagreements and usually represent little remedy to serious problems.

**A New Vision of Health Reform**

The only real answer to what ails our nation's health system is to make our entire system work – and work much better for the patient, provider and payer alike. We need to focus on the hard work of better managing the allocation of dollars we now dedicate and ensure we are obtaining the best value for our trillion-dollar plus health care investment. In short, we do need to transform the nation's indisputably inter-related public/private health care system into one that is more modern, more accountable and derives greater value for the money.

Today, I want to focus on four ways to achieve greater accountability and affordability in Medicare and Medicaid, as well as throughout the nation's health system. We can achieve this laudable goal by: (1) better managing and coordinating care for the chronically ill; (2) substantially improving productivity within the health care delivery system; (3) developing evidenced-based benefit packages; and (4) applying the strengths of both the public and private sectors to any reforms this nation pursues, recognizing that neither has a monopoly on wisdom or positive outcomes.

**(1) Better Managing and Coordinating Care for the Chronically Ill**

First, we must focus on the real driver of health care costs – the expenses associated with care for the chronically ill. As Senator Conrad has pointed out, only 5 percent of the Medicare and Medicaid populations account for nearly 50 percent of these programs' costs. What is perhaps even more startling is that health care spending for a person with one chronic condition is two times greater than spending for someone without any chronic conditions, while spending is about 14 times greater for someone with five or more chronic conditions. Beneficiaries with five or more chronic conditions represent 20 percent of the Medicare population, but account for 66 percent of the spending. (*Chronic Conditions: Making the Case for Ongoing Care*; Partnership for Solutions, December 2002).

At least as important, of course, is that chronically ill Medicare beneficiaries have historically received poor care and, as a consequence, had poor (and not just expensive) outcomes. When one considers the state of medical practice on behalf of these vulnerable Americans it is perhaps not surprising that this is the case.

Chronically ill Americans are too frequently forced to cope with totally inadequate coordination between their multiple health care providers. There is poor adherence to prescription drug regimens by beneficiaries because there are so many medications being taken for so many conditions. Moreover, there is often-times even worse communication between and amongst health care professionals who may even be unaware that there are other physicians prescribing medical treatments that may be at odds with care beneficiaries are already receiving. The result is unnecessary and expensive hospitalization or nursing home placement.

Unfortunately, our current system has too few health professionals in the system who have been tasked to help navigate patients through the complicated web of modern health care delivery. And, likewise, there are too few patient advocates who can help seniors access non-medical services, such as transportation or meal services, which can make all the difference in the world to maintain good health and remain out of expensive institutional care settings. Simply put, the result of these shortcomings is poor outcomes as well as costly and inefficient care.

Recognizing these shortcomings, we at Ovations pioneered demonstrations in 1987 with our Evercare product that were designed to serve frail, disabled, elderly and chronically ill populations with complex medical and social needs in both nursing homes and community settings. In five, and soon to be six states (currently in Arizona, Florida, Massachusetts, Minnesota, and Texas and soon in Washington), Evercare integrates Medicaid and Medicare benefits and provides a geriatric care manager who coordinates all acute care, long-term care, prescription drugs and social services for each member. Evercare also has been providing services to the British National Health Service since 2002.

The coordination of care by our nurse practitioners translates into comprehensive medical reviews of the range of conditions each patient has as well as the services they are receiving. This process includes a review of all the medications chronically ill beneficiaries are receiving and red flags any obvious problem for review by the patient's physician(s). Our nurses are also trained to help address psychosocial issues and service needs (like "Meals on Wheels," transportation, and respite services – which provide modest and brief breaks for caregivers).

The results of our work to date have been impressive. We have seen a 50 percent reduction in hospitalizations, a 97 percent satisfaction rating among families and a 20 percent reduction in the number of medications consumed by enrollees. In Texas, the implementation of our program in one county saved approximately $123 million from February 2000 to January 2002. In Arizona, our participation in its program has contributed to a dramatic turn-around in the use of community-based services over institutionally-based care.

We are proud to say that our success in improving outcomes and cost effectiveness for the nation's chronically ill received bipartisan attention and support from, among others, Senator Conrad, Finance Chairman Grassley, Senator Hatch, Senator Lincoln, Ways and Means Health Subcommittee Chair Johnson and Ways and Means Chairman Bill Thomas, and Representatives Ramstad and Cardin. Their leadership provided for the important inclusion of provisions in the Medicare Modernization Act (MMA) that authorize a major expansion of these chronic care management programs within the Medicare program in both the managed care and fee-for-service sides of the program.

We are pleased to report that we intend to be very active in this arena by participating in Special Needs Plans (we have already transitioned all of our Evercare demonstration programs into SNPs, and have plans to develop other SNPs) as well as the traditional fee-for service Chronic Care Improvement Program (CCIP). These new options will provide chronically ill beneficiaries the choice to enroll in chronic care programs with well-trained care coordinators, prescription drug monitoring plans, and other enhanced benefits.

There no doubt will be transitional challenges for Medicare, for beneficiaries and for participating plans. For Ovations, we believe it is extremely important that there be a workable and accurate risk adjustment payment that reflect the actual population served in the Special Needs Plans. We were recently awarded one of the CCIP contracts, and will be working with the Visiting Nurse Service of New York to serve chronically ill beneficiaries in Brooklyn and Queens.

Over time, we see these programs achieving substantial savings for beneficiaries, the Medicare program and taxpayers by avoiding hospitalization and nursing home placement. We have invested in enhanced benefits for beneficiaries, which will be designed to maximize our success at keeping health care affordable.

As for Medicaid, we hope to be able to rapidly expand the use of our Evercare integrated care model for this program. For the nearly seven million Americans who are dually eligible for Medicare and Medicaid, we believe there is great potential to improve care and achieve savings. We hope to accelerate expansion of our program, but also recognize that we face a number of barriers, including a complex and time consuming federal Medicaid waiver process. Also, prior to broader implementation of these programs, some stakeholders have reservations about this model. We well recognize that part of our mission is to illustrate that the services we provide can have benefits for all stakeholders and we are striving to do just that.

Chronic care management must be a central component of both the Medicare and Medicaid programs. It can no longer be treated as a peripheral and sporadic boutique concept. Chronic care costs are the driver of the primary challenges confronting these programs and must become the focal point of our commitment to improving care and constraining cost growth.

**(2) Substantially Improving Productivity Within the Health Care Delivery System**

Second, as we are targeting the number one cost driver of catastrophic expenditures, we must apply the same types of productivity demands we have done in the rest of the business sector. In short, as we have done in virtually every other sector, we must make our health system more efficient and accountable utilizing the most up-to-date and appropriate technologies and management techniques.

Productivity in the health care sector has consistently operated at levels far lower than in the economy as a whole. If American health care productivity were simply on par with that of the American economy as a whole, we would see improvements in care and increased financial resources. We have found that technology can bring improvements in productivity and, most importantly, patient care in several ways:

- **Improving the way work and patient care is organized.** We have found that fully engaging our work force makes their work more rewarding and interesting. Shifting the organization of our customer service teams from a traditional factory model to an engaged neighborhood model has resulted in increased productivity.

- **Empowering the workforce to improve patient care through appropriate use of technology.** Technologies represent tools to improve and enhance the work of caregivers. Using technologies, such as internet applications, consumer cards, and e-prescribing decrease administrative costs and complexity as it improves care and medical outcomes. New ways of working and better informed patients and caregivers are keys to success. In other words, technology as a stand-alone resource is important but it cannot achieve positive outcomes on its own.

- **Instituting rapid learning models to strengthen our knowledge base about good care.** We have found that holding a case conference every time one of our Evercare members is hospitalized helps us learn new ways to keep the patient healthy enough to avoid future hospitalization. As we gain new knowledge, we can and we do rapidly apply this information to new practices to avoid recurrences of old problems.

While productivity cannot be legislated, legislation using standards and investing in technology infrastructure can help make improvements possible. The keys are reward structures tied to preferred outcomes, incentives for investment in productivity tools, like technology, and regulatory processes that minimize delay and expense.

One of the keys to productivity increases is greater use of health information technology (IT), which makes it possible to pay more for desired outcomes and facilitate effective patient choices through transparency of results. Other business sectors have used IT successfully to increase productivity, and health care can learn from those sectors. Understanding that there will be up-front costs involved, promoting greater use of IT begins with our clinicians. At UnitedHealth Group, we have invested over $1.5 billion in new technologies and approaches.

We also need to make interoperability understandable to people by allowing information to be portable and to move with consumers from one point of care to another. The outcome will be transparency of results, which will facilitate effective patient choices. This is another area where the federal government can be helpful by developing universal standards related to interoperability of health IT. Without some type of standards, it is very difficult to create portable IT tools for consumers.

Productivity improvement is possible, feasible and desirable for the U.S. health sector. Research has shown that as much as 26 percent of productivity improvement since 1995 may be directly related to good information systems, and even more may be indirectly related to the actions people take to improve performance. If health sector employees increase their productivity at par with employees in the non-farm business sector, we should be able to enjoy necessary and sufficient health care from the current health sector labor force at affordable levels of investment.

**(3) Building an Evidence-Based Benefit Package**

Another way to constrain costs and improve care is to develop a national consensus around a clinically defensible, evidenced-based health insurance benefit package. We need to ensure that the best treatments are covered and encouraged, just as we need to stop subsidizing benefits that are harmful or ineffective. In the absence of doing this, we will have a wide variety of benefit packages that serve neither the patient nor our nation's taxpayers.

To make progress in this area, we need to invest in research to develop an evidenced-based benefit package. Last year, in the Medicare Modernization Act, we took steps towards this end by investing in comparative effectiveness for drugs and devices. The MMA authorized an investment for the Agency for Healthcare Research and Quality (AHRQ) to conduct research on outcomes, comparative clinical effectiveness and appropriateness of health care items and services, including prescription drugs. Publicly funded comparative clinical effectiveness studies of prescription drugs and other treatments will provide science-based, objective information on the relative clinical effectiveness of different prescription drugs and other therapies used to treat the same condition. This type of information will provide physicians, pharmacists and other health professionals, patients, and private and public purchasers of health care ready access to objective, authoritative, reliable evidence and information regarding the clinical comparative effectiveness of prescription drugs in order to make the best decisions when selecting drugs for the treatment of patients.

Now we need to continue down that road by empowering an independent entity to develop an evidence-based benefit package, which is clinically based. This entity should be akin to a private/public Institute of Medicine (IOM) that could develop a benefit package and share their research with private and public purchasers. In this way, we can ensure that neither the government nor private insurers are subsidizing wasteful care and creating disincentives for cost-effective, appropriate care. The federal government can play a critical role by funding such research and, over time, consider realigning tax incentives for the widespread use of evidenced-based insurance packages.

**(4) Applying the Strengths of Both the Public and Private Sectors to Health Reforms**

And fourth, all too often we find ourselves in a counterproductive debate between public and private sector approaches to health care. I work for one of the nation's largest well-being companies, yet I would be the first to acknowledge the importance and benefits of public programs, and the need for a public-private partnership.

Indeed, the reason why Medicare and Medicaid exist is because there was a very accurate recognition that the private insurance industry alone could not be able to universally provide reliable, affordable insurance to the oldest and poorest of our citizens. They are a very difficult population to insure and, in the absence broad participation, financing and general oversight rules, a substantial number of some of our most vulnerable fellow citizens would go without coverage or would cost-shift to others. While we must recognize and address the serious financing and delivery shortcomings of these programs, we must also acknowledge their critical role and need for their continued existence. Likewise, seeing private plans as the focal point of all problems within our health care delivery system is also unconstructive. The truth is both government and companies have very definable and unique strengths. They include:

- Public programs are better at operating a consistent health system nationally, at concentrating resources on the most vulnerable populations and enforcing operational rules that ensure fairness to beneficiaries and amongst plan and provider competitors.

- Companies can innovate more rapidly, can adapt to local areas needs and strengths more quickly, have great pressure to be efficient, have easier and more rapid access to capital resources and skilled staff that can quickly apply innovations to address priority infrastructure needs.

We must understand that both the public and private sectors have essential roles to play. And both bring strengths and weaknesses to the table. The opportunity is to take advantage of each sectors' strengths and maximize their advantages within a more flexible, responsive and cost-effective health delivery system.

**Conclusion**

I am confident that the issues and initiatives that I have raised this morning have great potential to substantially respond to and relieve some of the major cost and financing challenges we face. However, there is no silver bullet that addresses all of the cost, access, quality and demographic challenges facing our multi-faceted health care systems.

As this nation ages and the number of older Americans doubles from 40 to 80 million, there will be more health care dollars spent. Covering and treating millions of more seniors will cost billions of dollars more. This fact should not be surprising or troubling. We invested more on colleges and job training programs for the baby boomers, and it led to an explosion of productivity and an extraordinarily strong economy. However, if baby boomers through their 60s, 70s, 80s and beyond experience a transformed and more cost-effective health care delivery system, we can reduce per patient costs substantially below current projections while improving health status, lessening suffering and extending life.

Moreover, if we focus persistently on the key areas that can make a difference in improving our health care system, I believe we may well find that the health challenges we face will not be as severe a drain on our economy and our budget as many fear. More specifically, if we prudently manage chronic care costs, utilize a modernized and more productive health care delivery system, use a more rationale, evidenced-based benefit package and take advantage of the strengths of both the public and private sectors, we will make enormous inroads on the seemingly overwhelming challenge ahead of us.

We at Ovations and throughout UnitedHealth Group hope that we can be a constructive force to that end, and we look forward to working with you in the weeks, months and years to come. We appreciate the committee's leadership on this important matter and thank you for the opportunity to share our thoughts. I would be happy to answer any questions you might have for me.

Chairman GREGG. Thank you, Ms. Quam, and I thank the entire panel for a truly excellent presentation, which gives us a lot to think about. What I appreciate is it gives us some substantive ideas to pursue.

Just to quickly summarize, as I understand it, what Dr. Saving is saying is that we are heading toward one heck of a train wreck, but that there are things that we could do that would slow the potential there, and the area of making people more cost-sensitive in their purchasing was one item I heard him suggest. And then Dr. Brown was talking about maybe creating incentives for savings which pre-fund some of this liability. And then Ms. Quam has outlined a number of interesting initiatives which would be sort the hands-on, how-to-do-it-better answers.

This committee deals in the big numbers. Finance deals in the specifics, usually, on this. And I hope that we can get your specifics over to Finance. But dealing with the big-number question, I guess I would like to start with the Medicaid issue because the President has addressed that in his budget. He did not address Medicare in his budget. I happen to think we should address Medicare, but I may be a voice in the wilderness on that one. And I have to produce a budget. So I am looking for votes.

So to get to the point of Medicaid, Dr. Brown, maybe you could talk about this a little bit. What the President, as I understand it, is basically suggesting is that we try to slow the rate of growth of Medicaid from about 41 percent over 5 years down to about 34 percent over 5 years. The way he suggested that it be done is that we address a number of different elements: first, the issue of better handling the spend-down problem; second, the issue of giving States much more flexibility with the dollars they receive; and, third, the issue of making sure that Medicaid is spent on health care versus on general fund operations within the States.

The first year of his proposal, as I understand it, basically represents a reduction in rate of growth of about—well, about half a billion dollars, $500 million, on a spending base of over $190 billion. So it would seem to me to be—those types of restraints would seem to me to be attainable. Do you think that they are attainable?

Mr. BROWN. I think the specific cost savings that are built into the President's budget are achievable. It is important, though, to distinguish between policy changes that lower the level of spending, a one-time reduction in the level of spending that then might last forever, versus things that actually change the rate of growth.

Chairman GREGG. Which, of course, goes to your second point. I would be interested in your second point. But you feel on the first point that we could make those types of numbers?

Mr. BROWN. I do not have any reason to believe that we cannot. I will put it that way.

Chairman GREGG. So on your second point, what are the systemic issues which we should put in place to pre-fund the liability, as you mentioned earlier, and other ideas you have in that area?

Mr. BROWN. Sure. Let me address the issue of pre-funding specifically, and this is something that is an issue that cuts across any number of entitlement programs, be they Social Security, Medicare, or Medicaid. When I am thinking about pre-funding in a Medicaid context, there is a sense in which that is most appropriate for some

of the longer-term sort of long-term care type of issues that directly affect the elderly.

There is a sense in which it is more difficult to think about pre-funding that piece of Medicaid which is specific to, say, providing acute health care for children and so forth. But in the context of thinking about the elderly, which is the part of the program which I am most familiar with, one of the things that distinguishes long-term care is that almost anyone in this country has a risk of needing long-term care services in their lifetime and they tend to happen late in life. If you look at a group of 65-year-old individuals alive today, for example, roughly a third to even 40 percent of them can expect to spend some time in long-term care during their lifetime, women more so than men. And the average age of entry into, say, a nursing home is in their early 80's. So this is a type of cost which is a substantial, large risk, and is for most young people today far off into the future. In that sense, it is the perfect type of program to be thinking about how do we get people to set aside money today in a way that pre-funds their future expenditures.

Achieving this is, unfortunately, difficult. I am happy to go into more detail if you want. The rules of the existing Medicaid program that require that people spend down their resources means that Medicaid is not necessarily a very good insurance policy for people in the sense that it does not allow them to protect their wealth. But, on the other hand, it is sufficient to sort of crowd out most of the income distribution from wanting to buy private long-term care insurance policies today. And so it is a little bit of a catch–22 from a policy standpoint in that we are providing a publicly provided means-tested program for people who do not have the resources to pay for care themselves. It might not be a great form of insurance, and yet it is enough to crowd out what might arguably be better forms of insurance.

That is a tough problem, that is a very tough problem to deal with. But I think in general what we need to be thinking about, not only with regard to Medicaid but with all of these programs, is how do we set up a system so that rather than continuing to pay for these on a pay-as-you-go basis, we find ways of encouraging national savings more broadly.

Let me just say one other thing, and then I will take followup questions if you would like.

When we think about the role of national savings, it is not necessarily important that that national savings be earmarked for any one particular use. If you think about it, the real trust fund in this economy is the economy itself. And the role of national savings is to provide resources that the economy can invest, grows the economy even larger, so that hopefully economic growth can try to keep up or possibly outpace some of the growth in expenditures. And as long as we do additional saving today—and that can be done through Social Security, through the pension system, through some of these programs that have been proposed to encourage savings among children, things like that. That helps grow the economy and provide the resources that we can then draw on in the future to help pay for some of these costs.

Chairman GREGG. Thank you. I have a lot of followup thoughts and questions, but my time has expired, so I will turn to Senator Conrad.

Senator CONRAD. Thank you, Mr. Chairman.

Dr. Saving, what are the economic growth estimates that underlie the projections that you gave us?

Mr. SAVING. Well, really we are assuming productivity growth, but they have actually very little to do with this because if you think about the growth in gross domestic product and if health care has been consistently growing faster than gross domestic product, increasing the rate of growth of gross domestic product is not going to help you because health care is simply going to grow that much faster. So you cannot—in a sense, to the extent that the amount of health care that people want to consume is related to their income, and if we give them more income, if they want to consume even more health care, then we actually worsen this deficit that we are talking about.

Senator CONRAD. But, understand, we are the Budget Committee, and on the Budget Committee economic growth matters a lot.

Mr. SAVING. Oh, yes. No question about it.

Senator CONRAD. Economic growth determines how big the pool of resources are that we are going to have to draw from to sustain all of these programs. So this is a relevant question, and I assume that the underlying forecast that you are using is what the Social Security Administration is using, what the Congressional Budget Office is using, which is about 1.8 percent a year.

That is their estimate for the next 75 years, 1.8 percent a year. I contrast that with what has happened over the previous 75 years, which is roughly 3.4 percent, and it seems to be a very pessimistic outlook for economic growth.

Now, the reason for that pessimism is they see new entrants to the work force combined with productivity as the underlying factors that determine economic growth, and they see a dramatic reduction in new entrants to the work force with productivity basically humming along at 1.6 percent.

But one of the things I want to caution my colleagues about is the notion of solving Social Security for all time. Most plans have been focused on 75 years, and I tell you, I have grave doubts about these projections. The truth is we were told 4 years ago that we were going to have $5.6 trillion of surpluses over the next 10 years. That proved to be wrong. That proved to be totally off the mark. So I want to just enter a note of caution, about these 75-year projections. I have grave doubts about them. They are very pessimistic forecasts. With that said, we still have a problem, and the problem is the size of the baby-boom generation.

I would like to go to Ms. Quam for a moment, if I could. You laid out three very specific areas where we might make progress. Just for the record, I assume that each of these areas would also help us on the Medicaid side of the budget.

Ms. QUAM. Yes, they are as powerful on the Medicaid side of the budget as they are on the Medicare side.

Senator CONRAD. You talked at some length about the chronically ill and the fact that just a small percentage of the people are

using most of the resources. It seems to me that tells us we ought to focus like a laser on the chronically ill.

You also mentioned something about productivity in health care, and you made a statement that caught my attention. You indicated that if productivity in health care were the same as it is in other elements of the private sector, we would not have a shortage of resources. Could you just go a little further in describing what you meant by that?

Ms. QUAM. Yes. When you look at the productivity of the American economy by sector, the health care portion of the economy has lagged in terms of productivity, that is, it has cost more to provide services. There have not been the gains in productivity in terms of output per worker or other ways that you can measure that as there have been in the rest of the economy. And that is part of the reason why we experience much higher costs.

If we were able to get health care working on the level of productivity as the rest of the economy, we would have an enormous freeing of resources you which we could address these questions. You will find pockets within health care that function very productively, and they can provide us with best practices, clues about ways of spreading that across the whole. But, in fact, that is our challenge. And to me it says that that challenge is surmountable because surely it is not inherent that it has to operate in so much less productive a manner.

Senator CONRAD. What are the key reasons that there is less productivity, in your judgment? Obviously, you have spent some time trying to understand this with respect to your own company. What is your assessment of why productivity has lagged?

Ms. QUAM. Well, I think there are many. I think one relates right back to the discussion around the chronically ill. The focus has not been on those areas where we can make most of a difference. Since most of the spending is in this area, and since, in fact, despite this level of spending, this group has fairly poor outcomes, there is a huge opportunity to do better.

Second, relating to my point around evidence-based benefit packages, we actually know a lot about what works in medicine and what does not. We need to know a lot more. We need much more research. But there is a vast amount of time between when a research finding comes out and when it is generally applied in practice. And during that period of time, we pay for lots of things that are ineffective or even harmful for people. So establishing frameworks and incentives to be able to make changes more quickly that are productive is at the heart of what we need to do to improve productivity.

Senator CONRAD. Thank you. My time is up.

Chairman GREGG. Senator Alexander.

Senator ALEXANDER. Thank you very much, Mr. Chairman.

I have a question about Medicaid, and I want to ask for your help, the help of the panel. And trying to follow the example of Senator Conrad, I actually brought a chart to help.

Let me try to put this into perspective. Twenty-five years ago, when I was Governor of Tennessee, I came to see President Reagan, and I asked him to make a swap. I said let's swap Medicaid and elementary and secondary education. We States will take

all the responsibility for K–12, you take Medicaid. And he liked the idea, but nobody else did.

And then all during the time I was Governor—and we have a former Governor who is chairman—I had to work through the problem of trying to keep health care spending under control so we could fund universities such as the ones that two of you are associated with.

Now, here is what happens with Medicaid. The Federal Government sets the eligibility rules, tells the States these are the core areas you must fund, and sends some money. And so what had traditionally happened is that State spending on such things as Texas A&M and the University of Illinois and the University of Tennessee goes up at the rate of 5.5 percent. That is the blue lines through here. But State spending on Medicaid goes up 15 percent.

Now, there was a blip on that when the welfare law was passed in the mid-1990's, but now we are back to the same thing. And so when I left the Governor's office in 1987, we were spending 51 cents out of every State tax dollar on education and 15 cents on health care. Today it is 40 cents on education and 31 cents on health care, and one of the results of that is we will not continue to have great research universities like Texas A&M and the University of Illinois if States cannot properly fund them.

Here is my question: I support the idea of saying we have to reduce the amount that we increase, Federal spending on Medicaid. But when we send that problem back to the States, they are likely to have to increase spending on Medicaid, and it is already more than they are increasing spending on everything else. And why is that? It is because we set the eligibility requirements up here and they cannot change them, and the second thing that happens is the Federal courts get involved and they do not let the States make changes.

In Tennessee, the Governor is trying to reduce an optional program, and a Federal judge just decided the Governor cannot do that. And the legislature may have to go into recess just to wait for the Federal judge to decide what to do. The same thing happened in Arkansas. The same thing happened in Mississippi.

So my question is this, and I am really asking for help from the chairman and the ranking member: If we are going to tell the States that you must continue to spend more on Medicaid than every other thing based on these eligibility requirements we have set here, but we are going to cause you to have to make even greater reductions in growth, then how are we going to make sure they can do it? Can we write some language either into the reconciliation act or into other legislation that requires the Federal Government to give States more flexibility and makes it less likely that the courts will interfere with their decisions? That is my question.

Mr. SAVING. I would respond first by saying that the issue that you raised, Senator Alexander, about flexibility is extremely important. The only way that you can get things to be better is for people to try experiments. Those experiments have to be done on a small scale. You are not going to have a national experiment, and I would take welfare reform as a case in point; that if it were not possible for individual states, like Wisconsin, to experiment with things and to show you that something worked, and the things that do not

work, of course, will not be adopted, but they have to have flexibility. Without flexibility, with a national uniform program, you are not going to have change. And you want States to experiment. When programs do not work, we will abandon them because that is the way business operates.

Senator ALEXANDER. But, Dr. Saving, just to hone in on my point, we have a Democratic Governor in Tennessee who has decided that if we keep growing Medicaid at the rate it is growing, we will not have a University of Tennessee or a K through 12 or a city park or anything else. And so he has decided that he wants to take 323,000 people off the rolls. These are optional programs. The Federal Government does not require that these people be served, and the Federal court is stopping him. The Federal court is stopping him.

Now, how can the Federal Government, how can we blithely pass a law up here and say, "OK, you spend less money," and then the State does not have the capacity to do that? What could we write into the law that would stop that and also encourage the Federal agencies that administer the program to give the Governors more flexibility?

Mr. SAVING. I would like to be able to respond to that, but, unfortunately, that is outside my—that is your expertise, Senator. It is outside mine, I think, in terms of how you might keep the Federal courts out of, with the flexibility, but it is clear that we have given it in the welfare program. We gave variances so that States could try experiments. Now, that is an experiment that, clearly, we might allow a State to try because that, in a sense, is within the law, but I merely meant, within the current law, allowing States to deviate from those experimentally to see if there was a way to reduce expenditures that worked and that did not harm the participants, and that is what we are looking for here.

It may be the case, of course, some of those will come under, as a lot of the welfare reform things in Wisconsin did, and have to get by those issues. And how you get that legislation that takes the courts out of it is beyond my expertise.

Chairman GREGG. Senator Alexander's time is up, but go ahead.

Ms. QUAM. Thank you, Mr. Chairman.

Senator Alexander, it surely is not in the national interests to have this situation where we cannot invest in education. And if Medicaid reduces spending, of course, in many ways, it gets shifted then to county levels or health care providers. So our challenge is to figure out how Medicaid can cost less, and I want to just offer you four ideas, if I could.

The first is, is providing integrated programs for the dual eligibles. These folks, right now, get lost between Medicare and Medicaid. In Arizona, for example, for over a decade, we provided services for both Medicare and Medicaid. We have to have separate programs, separate administrations, separate everything to care for the same person, and it is not nearly as effective, and it is much more costly to do.

Second, connected with that, if States could invest in areas where these dual eligibles that they are principally responsible for that gets savings to the Medicare program and gets that recognized, that would help. We often talk with States that are consid-

ering investing in case management programs for these people. And the cost of those programs is borne by the State. The result of those programs are savings and reduced hospitalizations, and those savings and reduced hospitalizations go to the Federal Government. So, again, they are lost sort of between these programs. It is not an integrated view.

Third, it would be possible to authorize waivers. The waiver process now is very time consuming and diminishes the flexibility States have to respond to these situations. There has been some Federal legislation that has preauthorized waivers under model circumstances. They have been very small. That could be done more broadly.

And then, finally, I think there is an opportunity to recognize some benefits of an improved regulatory process. The regulatory process has both quite lengthy delays which do not correspond well to State budget pressures. And, second, it would be useful I think at times to consider whether all of the regulations are worth it in terms of the lost opportunities for savings. Sometimes, obviously, we need regulations, but sometimes those are not looked at together. And put to that test, it may be able to come to something more effective.

Senator ALEXANDER. Thank you, Mr. Chairman.

Thank you, Ms. Quam.

Chairman GREGG. Thank you for those excellent thoughts. I wish this committee had legislative authority over Medicaid because I would like to institute those. But there are a number of Finance members on this committee.

Senator Nelson.

Senator NELSON. Continuing on Medicaid. Right now, in Florida, they are currently discussing a change that would require Medicaid beneficiaries to shop for private coverage. Now, I would like, Dr. Brown, your opinion. That has a certain appeal to it, but what is your opinion about how could such a system care for those with severe cognitive problems such as Alzheimer's or mental illness?

Mr. BROWN. I am not familiar with the details of what is being done in Florida, but, in general, I think it is certainly worth experimenting with ways of involving the private sector, but one needs to be very careful about what we economists call the issue of adverse selection or what might be called cream-skimming or cherry-picking have you, which is the notion that, if it is going to be done, it needs to be done in such a way to where the private sector is not just picking up the good risks and, essentially, leaving the more difficult, more expensive population sector because that is just going to sort of shift those costs around.

As I said, I do not know the details of the Florida program, so I am not sure to what extent they have been successful at doing that. But as Dr. Saving said, one of the nice things about experimentation at the State level is that we can hopefully learn from those types of experiments, and hopefully only expand the ones that actually work.

Senator NELSON. Going back to Senator Conrad's chart, where he was pointing out the increasing cost of the Medicare prescription drug benefit, any one of you, what would be your opinion of the cost savings that would occur as a result of us changing the law

where the Secretary of HHS would be allowed to negotiate on behalf of beneficiaries in order to arrive at a price for the prescription drugs through Medicare?

Mr. SAVING. I am not a big fan of these negotiations, and I will say why, and I am not sure I can answer the question of what the savings will be. We have done an extensive study of what seniors paid for prescription drugs before the prescription drug bill came into effect. And the individuals who paid for the drugs entirely themselves actually got lower prices than any of the negotiated prices that we have seen, and we were using Medicare data for this.

So the more you care about what it costs, the more you shop. When you shop, you get lower prices, and since these prices were lower than the negotiated prices, it comes back to the issue that to the extent that the bill covers prescription drugs and gives people co-pays, then they are not paying for it. And when they stop paying for it all, they stop shopping. And when they stop shopping—you know our strongest thing about finding out about prices and about overcharges is if individuals care what it costs because then they will shop. They will spend some of their time.

As I like to say, when we were talking about up-coding and a big issue in Medicare, and we had to have investigators go into doctor's offices, to find out if they are up-coding, I said, "There is a reason we do not have to do that in a grocery store. Nobody is looking at the counter because the customer is looking at every item that gets rung up to see if they are being up-coded." We have to somehow make the individuals care what it costs to help us.

Senator NELSON. My question was not about shopping. My question is about negotiating in bulk purchases just like the VA Administration.

Mr. SAVING. Yes, I understand, and my point was that people who shop get lower prices. Our issue is how much will it help? And it may help. I do not know the answer to that question, though, because I have not investigated it.

Senator NELSON. Well, do you have an opinion with regard to the VA? They negotiate in bulk purchases. Does that tell us anything that would apply to the Medicare model?

Mr. SAVING. Well, you would expect that they should be able to negotiate similar prices. My point was that people who paid for the drugs themselves actually got lower prices, still lower prices by shopping. The problem with the bill is it relieves people from having to pay for it all. So then you are in a situation where they will wind up paying more, and then the VA program might well help.

Senator NELSON. And comparing apples to apples, in the VA system, does your answer that you just said apply to the VA, that they go out and shop, and that is why they get lower prices?

Mr. SAVING. They shop in bulk, yes, for these. They get bids, and individuals shop individually, but they wound up with lower prices than the VA did.

Senator NELSON. Thank you, Mr. Chairman.

Mr. SAVING. Sorry.

Chairman GREGG. Senator Bunning.

Senator BUNNING. Thank you, Mr. Chairman.

First of all, I would like to put an opening statement in the record.

[The prepared statement of Senator Bunning follows:]

Senator BUNNING. There are a couple of things I would like anybody that knows the answer can come up with it. The President has proposed in his Medicaid proposal closing some loopholes that States use. The budget proposes curbing the use of intergovernmental transfers States have used to avoid the legal-determined match rate for Medicaid. Through several accounting measures, Government providers of health care, such as county-run nursing home or a municipal hospital, returns a portion of their Federal Medicaid dollars back to the States. The State then recycles these funds to draw down additional Federal dollars or for other purposes. The budget proposes to match only those funds kept by providers as payment for services. It says that there will be about a $5-billion savings over 5 years and about a $12-billion savings over 10 years.

Is this a problem in a lot of States or do you know that?

Mr. BROWN. Again, my expertise in this is more in terms of the budgetary impacts of long-term care financing and so forth. So my knowledge of this sort of is——

Senator BUNNING. You do not know of any States——

Mr. BROWN [continuing]. Is limited to what I have seen the HHS Secretary——

Senator BUNNING. Ms. Quam?

Ms. QUAM. Yes, Senator. As Senator Alexander referenced, many States have seen incredible pressure on their budget through Medicaid, and they have gone to great lengths to then try to find ways to get a larger Federal contribution.

Senator BUNNING. So they are doing it, and it is a practice that might, if we could eliminate it, save some Federal dollars? We want to make sure that all the States are, if there is a share that they are getting and that is an actual share of cost, like Kentucky gets 70 percent from the Federal Government and pays 30 percent of all programs under Medicaid. I just want to bring Kentucky in specifically because Senator Alexander brought up the fact that a Federal judge has ruled in a specific way.

In Kentucky, there are currently 27 optional services provided under Medicaid. There are only 13 core programs that we must cover. According to the judge in Tennessee, those optional programs are not optional. In other words, they are challenging us and the judge is challenging Tennessee that they must cover what has been paid for because it was optionally paid for by Tennessee.

Would the Federal Government be better off not having optional programs or letting the State decide what is optional and what is not?

Ms. QUAM. Senator, I think the challenge we have now is that health care costs have gotten sort of too high for every part——

Senator BUNNING. That is true.

Ms. QUAM [continuing]. The Federal budget, the State budgets, corporations, families. And so we are going to have to really put a great deal of focus on how we get more for the current money we spend. And shifting, in some ways, has become less of an option as the costs have gotten so high, that if costs shift from Federal to

State, States have difficulty, and then if they shift to local, then the local areas have difficulty, that we really have reached something of a stage or a dilemma where we are going to have to look at how do we get more value out of the whole.

Senator BUNNING. The productivity thing interests me because of all of the areas that we have in the economy, you would think that medicine would be one of the most susceptible to new productivity because of the technologies not only in the way we use it, but other things, as far as drug development and things like that. Is that——

Mr. BROWN. I just want to make a comment about the productivity point, which is productivity in health care is a very difficult thing to measure, and let me just give you an example. Suppose that a pharmaceutical company develops a new drug for treating cancer, to take an example. It may be the case that this actually increases overall health care spending in the U.S. The sense in which we get benefits from that is that people are living longer, have better quality of life after being diagnosed and things like that.

And if you really want to think about health care productivity, you need to take into account those health benefits that people are receiving. So the question I often ask my students, when I am teaching in class, is would you rather have 2005 health care at 2005 prices or would you rather have 1980 health care at 1980 prices? Of course, the usual answer is, well, we want 2005 health care at 1980 prices. That is not an option on the table.

But the point is, is that health care is better today than it was 25 years ago. We are getting something for our money. The question that I think we need to ask, and it gets at the heart of this productivity question, but it is a very difficult thing to measure, is on each new drug, on each new investment, from a public standpoint, are we getting what we pay for?

We know that there are incremental benefits. We know there are incremental costs, and the question is which is larger?

In going back to Dr. Saving's point, one of the difficulties about health care in the United States is because consumers, by and large, are not facing the full price of their decisions, private insurers or Medicare or whatever is picking up part of the costs——

Senator BUNNING. Third-party payers.

Mr. BROWN. That is right. You know, I go to the doctor, and all I need to think about, when there is a prescription, is, is it worth $10 to me because that is my co-pay. And if I get $11 worth of benefits from that, I am going to do it, even if it costs society $100 to provide that prescription.

There are two concepts here. One is I think we need to be careful about how we talk about productivity. I think some of the productivity gains may be greater than what traditional productivity measures have suggested.

And, second, is I think it underscores the point that we need to find ways to get on the margin for people to have to think a little bit harder about whether the cost-benefit is worth it.

Mr. SAVING. There is another issue here that affects the way we measure productivity. If you were a private firm developing in a private market a new knee replacement, you would be asking yourself what people would be willing to pay for this knee replacement.

And if it were a $100,000-knee replacement, how many people would buy it, and what is it going to cost to produce it? And if not many people would buy it, but here you only say, if Medicare is willing to pay for it, it is free to everybody who takes it. And you have a whole different market. So the technologies that get developed in the private sector, you just would not have developed it because, in any other industry, it would not have worked.

And that helps productivity in those industries look better. Now, that does not mean that someone like me, an old person whose parts are wearing out, is not much better off because everyone else is subsidizing the system to do things which do not enhance productivity in the way we usually measure it. And I think therein lies a problem, and when we try to deal with this, we are encouraging these kinds of technological change. And they do contribute greatly to the rate of growth of health care costs.

Senator BUNNING. Thank you, Mr. Chairman.

Chairman GREGG. Thank you. Thank you for those interesting responses.

Senator Corzine.

Senator CORZINE. Thank you, Mr. Chairman, and I appreciate you holding this hearing. I think this is focused on maybe one of the most important topics we have. It is certainly going to dominate our——

Chairman GREGG. Especially for those who might be Governor.

Senator CORZINE. Yes. I am sort of trying to go to school on a few of you here.

[Laughter.]

Senator CORZINE. If I might be a little bit editorial before I get into a serious question. Dr. Saving, did I read in your remarks that you said Medicare's financing problems occur sooner than Social Security and the solution to its problems is more difficult?

Mr. SAVING. Well, to the extent that it is already in—you say HI is already in deficit last year.

Senator CORZINE. Right.

Mr. SAVING. So, in that sense, yes.

Senator CORZINE. And did I hear you say that whatever the indefinite infinity unfunded cost is something like $62 trillion——

Mr. SAVING. Exactly, yes.

Senator CORZINE [continuing]. Depending on, I presume, Social Security. We are having a debate about what crises and problems are, and I would just like to have that for background. And for a failed economic student at the University of Illinois, I am glad that Dr. Brown is here.

I would want to argue——

Mr. SAVING. You are going to get revenge on him?

[Laughter.]

Senator CORZINE. I was going to suggest that since we take a survey of young people in the country or at least I hear somebody says anecdotally that they think the likelihood of them getting their Social Security payments is about as likely as seeing a UFO, do you really believe that people are thinking about spending down their assets so that they can get Medicaid for their long-term care? Do you think that that really is a decision that is going on when people are making savings decisions when they are 25 years old?

Mr. BROWN. I, actually, use that survey in my class, and my class confirms it, that they are somewhat pessimistic about getting Social Security in the future.

Senator CORZINE. I guess they would be a little skeptical about getting Medicaid in the long term.

Mr. BROWN. Yes, I think it is fair to say that young people today are not thinking a whole lot about long-term care needs. What is more troubling is that when you look at 65-year-olds today, who have a fair amount of information out there, for those who are interested in looking, about the probability of needing long-term care. They have had family members and acquaintances that need long-term care. Among those that buy long-term care insurance, the average age is around sixty-five. But even at that age, there does not seem to be a tremendous amount of activity on the part of seniors to save.

Senator CORZINE. I think you and I probably have the same view, that there is a real savings problem in the country——

Mr. BROWN. Oh, absolutely.

Senator CORZINE [continuing]. On a whole host of issues that underlie how we get to resolving some of these issues. It was interesting that Chairman Greenspan yesterday used the term "forced savings," when he was talking about private accounts and Social Security. And somehow or another, on all of these various issues, we just do not have enough savings to take care of the demographic problem, whether it is through governmental programs or through a private program, so that there is a major shift of something that has to happen under any kind of category.

Ms. Quams, you start on this discussion about capping Medicaid. We can hold down costs on Medicare, but the costs do not go away, I do not think. I think we create a feel-good situation here in Washington because we controlled our budgets, but the last time I checked, at a hospital in New Jersey, they have a responsibility to take in people who come in with no insurance, and then they give out the care, if I am not mistaken, and then it is just a big charity care.

Can you walk us through? These problems do not go away just because we capped them or we say they do not exist. I do appreciate that there are specific challenges or specific steps. We can take on productivity and all of the other things. I think they are worthy of discussion. But we have a problem. There are sick people.

And I was also curious why you did not talk about catastrophic insurance, all of you, since that 5 percent is dominating 50 percent of the cost. Are there not directions that we can go in that area that maybe help solve some of this problem in conjunction with the other issues?

Ms. QUAM. Senator Corzine, you are correct. We have an overall problem. And where it all eventually gets shifted to is families. And as we have done some analysis and look at different family income and look at by county, so you look at average family income in a county, average housing costs, health care costs, other kinds of things, you see very quickly that this combination of costs, health care costs has increase in a dramatic way for families. That is very significant.

And your point on local providers of health care is exactly right. Hospitals are required to care for these people if Medicaid does not pay. And I think it is interesting to note that Arizona was the last State that put a Medicaid program in place. They did it in the eighties. And what finally propelled them to do it was that the local health care system was collapsing under the weight of caring for patients for which they were not reimbursed.

Medicaid pays for 40 percent of all deliveries in the United States. It is an essential part of what we do. So I think we have reached a point where, in some ways, there is not anyone to shift to that can bear it, that we have to seriously look at ways of controlling costs and, in particular, look at those people with these high expenditures because there is an opportunity to do better for them and to lower costs.

Mr. BROWN. I just wanted to make one point that it is certainly true that for a given level of expenditure, if you just reduce Federal Medicaid spending, that has got to show up somewhere else. Somebody has to bear that cost.

I think what we really need to be spending a lot of time speaking about is to what extent the structure of Medicare or the structure of Medicaid or the structure of how we pay for health care, in general, leads to additional increases in health care costs that might not be efficient from a social point of view.

I am not about to make a policy recommendation on this, like in the future, one might need to ask really difficult questions like just because a particular new procedure or a new drug is approved by the FDA, does that mean it automatically ought to be something that the public sector pays for?

There are all sorts of issues involved in terms of thinking about what is the proper role for what the Government ought to pay for using tax revenue, which we know has distorting effects on the economy, as opposed to things that ought to be left to the private sector. It is a big issue, a lot of research speaks to this, and it is broader than we can get in here today. But I think it is important not to forget that these programs can influence the level of spending and not just how it is divided up.

Chairman GREGG. Thank you very much.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman.

Chairman GREGG. I want to thank you for chairing yesterday.

Senator ALLARD. Well, thank you. We had a good discussion I think yesterday, and we were talking the very same subject I think you are kind of talking about now. And my staff informs me that we continue to talk about the 5 percent that consumes 50 percent of the resources, and that is a very tough issue, and it is a difficult issue. And, bottom line, I think we have to rely on the patient-doctor relationship to come up with the right answers, in many cases. And somehow or the other, we haveto facilitate this so that the doctor and patient feels some responsibility in the decisionmaking process.

You had just made a comment here about in Medicare, about the taxpayer should not be required to pay maybe for some procedures or some drugs. I believe we still have, in current law, and, Mr. Chairman, you are more knowledgeable on this, but I think we

have in current law now a provision that a physician who is taking Medicare patients cannot take private pay in addition to that. And as a result of that, I think they feel really constrained, and it is difficult for them to say, well, you know, maybe there is a procedure out here, the Federal tax dollars should not pay for it, but if you are a wealthy individual, you can pay for it, and you can go ahead and do it. I do not think that option is there.

Do you think that that provision creates some special problems as far as our health care policy is concerned and perhaps maybe it is something that ought to be looked at?

Mr. BROWN. I think all of these issues need to be looked at, and it is tough. I mean, at some level, what we, as a country, just need to decide is how much health care do we want and how are we going to pay for it?

The fact that health care expenditures are growing faster than the economy is not necessarily a bad thing if that is what we want to spend our money on. I think the issue that you are referring to is one which what people are concerned about is that we get into a situation where, if you are poor, here is the set of drugs you can buy, and if you are wealthy, here is the set of drugs you can buy, and there are concerns about equity and so forth.

But what I was trying to get out more was the issue of, as Dr. Saving was referring to with his knee replacement example suppose there is already a perfectly good knee replacement technology out there, and then someone is trying to decide whether to develop one that is slightly better. When we think about the net social gains to having this new knee replacement, it may be relatively small, but positive.

But because this is all paid for by public dollars, it is very much in that company's interests to do it. It can be very profitable for them. Once we have all these third-party payers in here, it takes away a lot of the market forces that would typically serve as a control on those costs. And my point is, simply, and again I am not recommending this, I am just saying these are the types of issues we need to ask ourselves, is to what extent should new drugs or new procedures or new technologies be required to pass some sort of a social cost-benefit test before the public sector pays for them? These are difficult questions. I am not even sure how one would implement that, but, I mean, those are the types of things I think we are going to have to think about.

Mr. SAVING. In that same vein, what are the incentives for I will say the need for someone to develop a cheaper knee replacement? And when there is no reason for them, the customers do not care what it costs, and what is the benefit of the cheaper—and that is the thing that, as productivity, Lois talked about productivity, productivity is better in the private sector because developing the cheaper way to do it is how you transfer the customers to yourself.

As we know, as we look, and a member of my board is the chairman of Radiological Oncology at M.D. Anderson, one of the top cancer hospitals, and when I speak to her, I like to say, "I just dream of the day when I drive to Houston, and I see a big sign, but for M.D. Anderson, and the biggest thing on the sign is the price. And you are telling me come to M.D. Anderson. It is $99 a day, everything included." I thought she was going to fall off her chair when

I told her that. But that is what we see for LASIK surgery, that is what we see for plastic surgery. The notion of the price matters to people.

And until we can make it matter to people, and the real issue is, as Jeff said, if you make it matter to people, do you take away the top tier, the Rolls-Royce of care, from everyone else? And do we have to have a system in which everyone is entitled to the Rolls-Royce of care? And those are very tough questions. That is what makes Medicare reform so difficult.

Senator ALLARD. I appreciate your comments, both of you, and I do think that we need to figure out ways of trying to make it more competitive out there. I agree with that approach. But the fact remains it is very obvious that we have a problem with Social Security that needs to be dealt with immediately. We have a big problem with Medicare that we need to think about at some point in the future. We have a big problem with Medicare, all of our entitlements, as a matter of fact, but particularly those three programs that we have to begin to deal with. And I think what we are struggling with and what we have to get some insight in is on solutions.

Most problems in medicine, if you make the diagnosis, the treatment is easy. This is one of those problems in politics, where you make the diagnosis, the treatment gets very complex, and is not so easy. And I am looking forward to hearing from you in the future about any suggestions on what we may do to bring some efficiencies to the program to make it so that we can begin to reduce the huge exponential growth that is happening in all of the entitlement programs, as we go out into the future.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you.

Dr. Allard?

[Laughter.]

Senator ALLARD. A little veterinarian medicine thrown in.

Mr. SAVING. Just send everybody to the vet, and we would have no problem at all.

[Laughter.]

Chairman GREGG. Senator Stabenow.

Senator STABENOW. Well, thank you, Mr. Chairman. I would just, on that note, indicate if everyone went to their vet for their prescription drugs, they would get the same medicine at about half the price. So that is one way to—maybe we ought to do that. We ought to be doing it.

Senator ALLARD. Well, we do not have as many lawsuits.

[Laughter.]

Senator STABENOW. Thank you all very much. This is such an important topic. And thank you, Mr. Chairman, for holding this hearing. I have many thoughts and comments. I think this is the most important issue, both from a moral standpoint and fiscal standpoint, that we have to deal with, as well as for businesses and family members.

On a personal note, just to bring this back to a human factor, I think the reality to the question of how much health care do we want is we all want health care for our families, and we all want to make sure our families are taken care of, that we are taken care of, that we can afford medicine, that we can get what we need. And

our challenge is to figure out how to do that in a cost-effective way without telling someone they cannot get what they need for their families.

I have a question, but I first want to put this in context. Other countries, other industrialized countries, spend about 9 percent of GDP on health care. We spend 15. This goes to the point that Ms. Quam talked about, which I think is so critical at this point. It is not that we are not spending money, but it is a question of how effectively are we spending dollars and what way. And I would urge us to look at the context of looking at all of health care and not just Medicaid and Medicare, which are our immediate responsibilities, because, according to CBO, Medicare and Medicaid, average spending growth on a per-capita basis in the last 4 years was lower than the private insurance, was lower than private insurance.

So we have to make sure we are looking at all of this so that we can address it and not just moving the deck chairs around on the Titanic. We need to be addressing it, as you said, Ms. Quam. And I would reinforce what Senator Conrad said. We have 5 percent of the public that is chronically ill, using 50 percent of the dollars. Evidence-based health care would say we should be focusing in that area, and there are a number of other issues that deal with evidence-based care that we need to address.

I, also, would just make the point that if we cut Medicaid and Medicare, our business community now understands that that rolls over into uncompensated care, which rolls back onto them. So, in Michigan, last year, we had over a billion dollars in uncompensated care folks walking into the emergency room sicker than they should be or getting care they could have gotten in a doctor's office or preventative care, if they are treated, as they should be, and then my private businesses see their health insurance rates go up.

So it is all connected, and the question is how do we more effectively do this and deal with tough choices. And I would suggest there are a number of tough choices beyond whether or not we buy new equipment. We have prescription drug prices on the blockbuster drugs going up 10 times faster than the rate of inflation. A tough choice would be maybe we ought to do something about that, in terms of accountability. So there a number of choices.

I would like to ask Dr. Saving, though, on the issue of prescription drugs and on pricing, you have indicated that the prescription drug benefit will "rapidly grow in its requirement on the budget." I am assuming that your statistics are assuming current drug prices; is that your assumption?

Mr. SAVING. Well, we are making assumptions about what is going to happen to pharmaceutical prices, so——

Senator STABENOW. You are assuming that they would be going up as a part of that?

Mr. SAVING. Is that they are going to rise at historic rates, and we taper them down. So we make assumptions about what is going to happen to pharmaceutical prices. And one of the things that Jeff Brown mentioned, are things about levels and rates of change. A lot of the things we have discussed today have to do with the level of expenditures and do not really affect how fast they are growing. And those have very small effects in total because you only simply

reduce something now, but it grows just as fast. The issue is a lot of this is about how fast these things are growing and not——

Senator STABENOW. Right, which, of course, they are exploding the prices.

Mr. SAVING. That is the issue. That is right.

Senator STABENOW. Yes. Let me just ask, though, when you talk about shopping around, one of the challenges I think for us in health care and in prescription drugs is that it is not like buying an automobile. I come from Michigan. We want everyone to buy one, and we want it to be made in Michigan. And it is not like buying a pair of tennis shoes or something else where you can say, "You know, I would really like a new pair, but I will wait a year."

My sister-in-law was diagnosed last year with breast cancer. Her doctor gave her a prescription for medications. She could not say, "I will wait until next year. I cannot afford this."

So we have a different way which we approach this because the marketplace is different. And so I would ask you, when we look at this, if we shop around, and if I am walking in by myself to a pharmacy right now without an insurance plan to negotiate for me, I pay the highest retail prices in the world, but if I have somebody who negotiates for me, I do not.

We have the VA, as an example. Zocor right now, a veteran will pay 66 cents for a pill. If I walk in by myself or my relatives who are veterans walking by themselves, they will pay $3.77 for a pill. Why would we not want to give Medicare the ability to negotiate 66 cents for a pill for others, rather than telling folks to go shop on their own, when it is something that they have to have?

Mr. SAVING. Well, I am not here to suggest how you might change things, although I have suggestions for that, but that is not my role here. But the research that we did looked at what bulk buyer are paying and what individuals paid who are paying for it themselves. As a matter of fact, when I presented this on the Hill somewhere—I think it was over on the House side—there was a woman in the audience who had just had breast cancer, and she was taking Tamoxifen, and she was going to have to take it the rest of her life. And she said, You know what you are saying is exactly right. I searched—because she was going to pay for it herself—she searched, and the prices ranged from something like $140 to $60, and so she went to the $60 pharmacy. Now, if she paid a $10 co-pay, she would have stopped at the first pharmacy she went to and taken the drug. It might have been the $140 one. And the difference is her shopping for the drugs, since she was paying for it. And it was as if I had had her in the audience. It was wonderful to have someone like that when you are giving a talk. I was not expecting her to be there, but she leapt up and said, "That is exactly right."

I am not suggesting that we give people the authority to do this. I am requiring it. For that to be the price, it may be some what difficult to make sure that everyone pays that price because it may be a higher price than some people would actually be able to get the drug for. So we have to be very careful of the——

Senator STABENOW. No question that folks should shop around. I am just suggesting it is a limited shopping if you do not have somebody negotiating for you, and that is why I have introduced

legislation that I hope my colleagues will support to allow, as our former Secretary Tommy Thompson said, he wished he had had the authority to be able to negotiate group prices, and I think that is a part of bringing prices down. But you raised one other point, and I know my time is up, but I am going to ask to pursue this just for a second on Tamoxifen as an example.

Part of shopping around and getting the best price is to be able to do what we can do for any other product, which is go across the border and safely purchase Tamoxifen. Again, in Michigan, I can go to Windsor, across the bridge, it is $60; in Michigan, it is $360 for a month's supply. Have you looked at issues on reimportation. And if you are talking about shopping around and the ultimate competition to be able to bring prices down would be to give our pharmacists the same ability to shop for people that we have for other products. And we have a very strong bipartisan group advocating this right now, but that is certainly is a part of shopping around, and I wondered if you had looked at that.

Mr. SAVING. No, we have not done research. I understand some of the economics of this issue and why the drug prices are different, meaning that certain foreign countries have suggested that if they do not get the price that they want to the pharmaceutical companies, they will allow other companies to simply make the product, and that has a longer-run issue, in terms of drug development. And this is a real issue that, say, you want to have the new exotic drugs, and if you were to control the prices of them, no one will develop again.

So I am not taking a position on this in one way or the other. I am simply saying here are the arguments on both sides of the issue.

Senator STABENOW. In Canada, for instance, they negotiate prices.

Chairman GREGG. Senator——

Senator STABENOW. Thank you, Mr. Chairman.

Chairman GREGG. Well, we want to thank the panel. You have certainly put on the table a lot of very interesting ideas and, obviously, some statistics which are fairly staggering and have significant implications for us as a society and for the Government, specifically. So we do thank you, and this concludes this hearing.

We will have, on March 1st, the Deputy Secretary of Defense. It will be a first for this committee to have that opportunity to talk to the Defense Department about a fairly large budget that they have, something I know the ranking member has been interested in having.

So we look forward to that testimony, but we very much appreciate your testimony. I am hopeful, quite honestly, that some of the ideas that you have put on the table, which have been very creative, will find resonance with the proper authorizing committee, and we will certainly try to energize that.

Senator CONRAD. Thank you all.

[Whereupon, at 11:43 a.m., the committee was adjourned.]

# THE PRESIDENT'S FISCAL YEAR 2006 DEFENSE BUDGET

**TUESDAY, MARCH 1, 2005**

U.S. SENATE,
COMMITTEE ON THE BUDGET,
*Washington, DC.*

The committee met, pursuant to notice, at 10:03 a.m., in room SD–608, Dirksen Senate Office Building, Hon. Judd Gregg, chairman of the committee, presiding.

Present: Senators Gregg, Allard, Sessions, Bunning, Ensign, Alexander, Conrad, Feingold, and Stabenow.

Staff present: Scott B. Gudes, Majority Staff Director; and Mike Lofgren.

Staff present: Mary Ann Naylor, Staff Director; and Jamie Moran.

## OPENING STATEMENT OF CHAIRMAN JUDD GREGG

Chairman GREGG. We will begin this hearing. We are joined today by Dr. Wolfowitz and General Pace and Ms. Jonas, and we are very fortunate to have these three individuals join us today. They lead the Defense Department, along with Secretary Rumsfeld, and have done an extraordinary job there. I believe this is a new precedent in that we have not heard too often from the Defense Department at the Budget Committee, and we very much appreciate Secretary Wolfowitz taking the time to come here today and bring with him his senior team.

This is important for us to have the Defense Department's input onto the budget. Obviously, the Defense accounts represent the most significant item in discretionary spending. It represents in a $2.5 trillion budget approximately 20 percent of the entire budget of the United States, and one that is clearly critical to where we are going as a Nation and how we maintain our independence and strength as a Nation.

I want to begin by thanking the men and women who serve this Nation and who work with you in the Defense Department. We have seen a display of extraordinary courage, ability, talent and intelligence in the way they have executed their duties in Iraq and Afghanistan and around the globe generally, but obviously in those two extremely intense environments. We are all very proud of them and we are very thankful for what they have done because it has been exceptional work. And their success is considerable. The elections in Iraq I think stunned the world because it showed that democracy could work and that there was a desire for it. And they came about because men and women on the ground in American

uniforms made sure that they were able to pursue an election there. We should take great pride in that result.

The recent actions in Syria and in Palestine also reflect that the awakening of the voices of democracy is occurring in the Middle East and it is in large part because of the commitment, the efforts of our soldiers in that region, making sure that people who seek freedom have the ability to pursue it without being stifled by radical terrorists or individuals who are despotic in their approach. So we admire what you have done, or I do, and I think I speak for most Americans, and we thank you.

The budget of the Defense Department, as I mentioned, is significant, and it is one that needs to be addressed in an open forum like this. I know many of my colleagues will have a lot of questions. My questions primarily will focus on how we are going to sustain our commitment to the Defense initiative as we restructure the force structure in order to meet the new threat of terrorism or the threat which now unfortunately we are deep into fighting. It is not that new any longer. But what is it going to cost us in the outyears? We know what it is going to cost next year. We can project what it is going to cost for maybe 2 years, but what is the long-term cost and where should we be reallocating resources and how should we do that? And how do we treat the issues beyond the Defense Department, which the Defense Department is pursuing or being drawn into, such as public diplomacy and nation building, for lack of a better word, protecting democracies, fledgling democracies? How do we deal with that and what is the cost as we move forward? Where will we adjust in other areas, which obviously there has been a lot of discussion about, and there are some major reports coming forward.

So we look forward to your testimony today. We thank you for taking the time to appear before us. We appreciate the courtesy you are showing us by being here today.

With that, I will yield to the ranking member of the committee, Senator Conrad, for his thoughts.

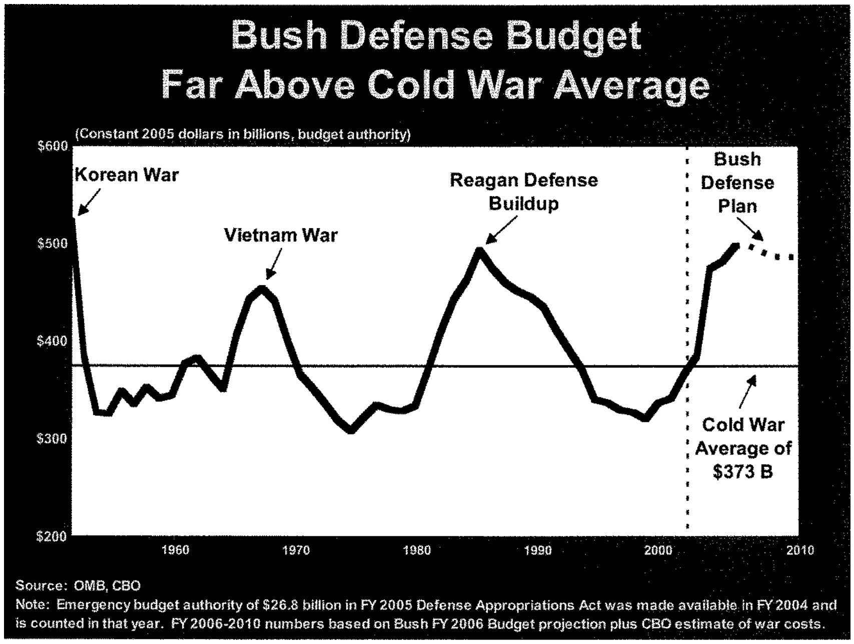
**OPENING STATEMENT OF RANKING MEMBER KENT CONRAD**

Senator CONRAD. Thank you, Mr. Chairman. I want to join the chairman in first of all thanking you, Secretary Wolfowitz and General Pace and Ms. Jonas for being here today. It is very important for the deliberations of this committee to have a defense panel before us, and we appreciate very much your taking the time to come and make a presentation here.

I also want to join the chairman in, through you, thanking the men and women in uniform. I think every American is intensely proud of how you have conducted yourselves at a time of great stress. I believe my State has the highest proportion of guard troops in Iraq. We are proud of each and every one of them, and we recognize their sacrifice and their service, and again through you, we want to express to them this Nation's undying gratitude. Whether one agrees with every element of the policy of the United States really should not have a place with respect to how we regard the men and women who meet the call of this Nation. That is an extraordinary thing that people do to answer this Nation's call at the time of need.

I would just like to put a few things in perspective in my opening remarks, and then we will get to questions. And I want to thank the chairman as well for holding this hearing.

I put up this chart just to put in perspective where we are in constant dollars terms, the Defense budget of the country over an extended period of time. What this chart shows is going back to 1950, coming off of the Korean War and the peak of the time of the Vietnam War which was between four and five hundred billion in constant dollars. Then the Reagan defense buildup, which was just about 500 billion in constant dollars, and now this buildup which appears to be, if my eyesight is correct, the highest in real terms since the Korean War. So we have a trajectory here that I think we all understand. It is a result of the war in Iraq, the war in Afghanistan. It is a result of the war on terror. Those are the things that are pushing up this Defense budget. Defense is where most of the increase in discretionary spending has occurred. In fact, 91 percent of the increase in discretionary spending is a result of the increases in Defense, Homeland Security and the other responses to September 11th, the rebuilding of New York, the airline bailout, et cetera. So the vast majority of the increase in spending that has occurred is in just those three areas.


Bush Defense Budget
Far Above Cold War Average
(Constant 2005 dollars in billions, budget authority)
$600
$500
$400
$300
$200
Korean War
Vietnam War
Reagan Defense Buildup
Bush Defense Plan
Cold War Average of $373 B
1960
1970
1980
1990
2000
2010
Source: OMB, CBO
Note: Emergency budget authority of $26.8 billion in FY 2005 Defense Appropriations Act was made available in FY 2004 and is counted in that year. FY 2006-2010 numbers based on Bush FY 2006 Budget projection plus CBO estimate of war costs.

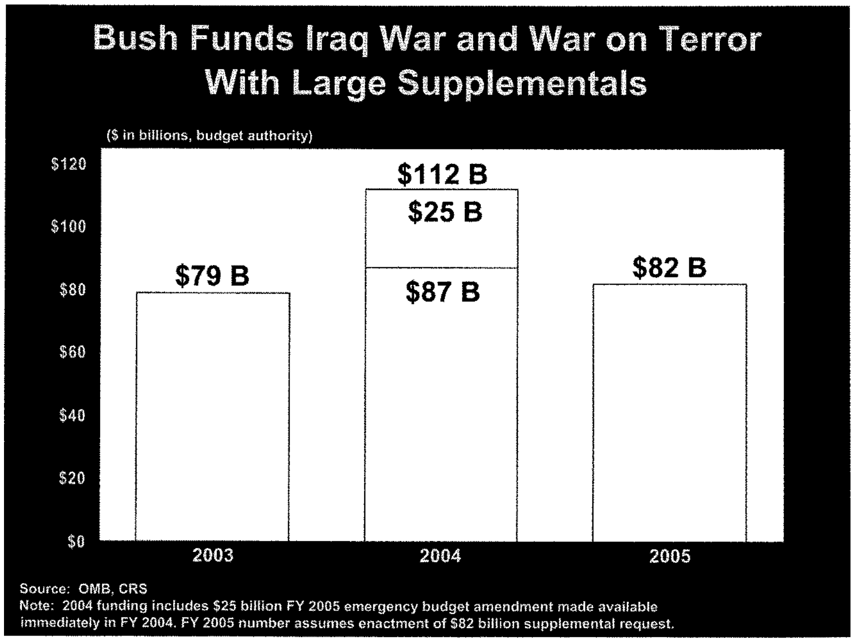
If we go to the next slide, I think the administration has been less than forthright with respect to what these costs would be. This is an interview with George Stephanopoulos in January of 2003 with the Secretary of Defense. And the interviewer asked this question: “What should the public know right now about what a war with Iraq would look like and what the cost would be?” Secretary Rumsfeld: “The Office of Management and Budget estimated it to be something under $50 billion.” Interviewer: “Outside estimates say up to $300 billion.” The Secretary: “Baloney.”

# Bush Administration Belittled Suggestions War Would Be Costly

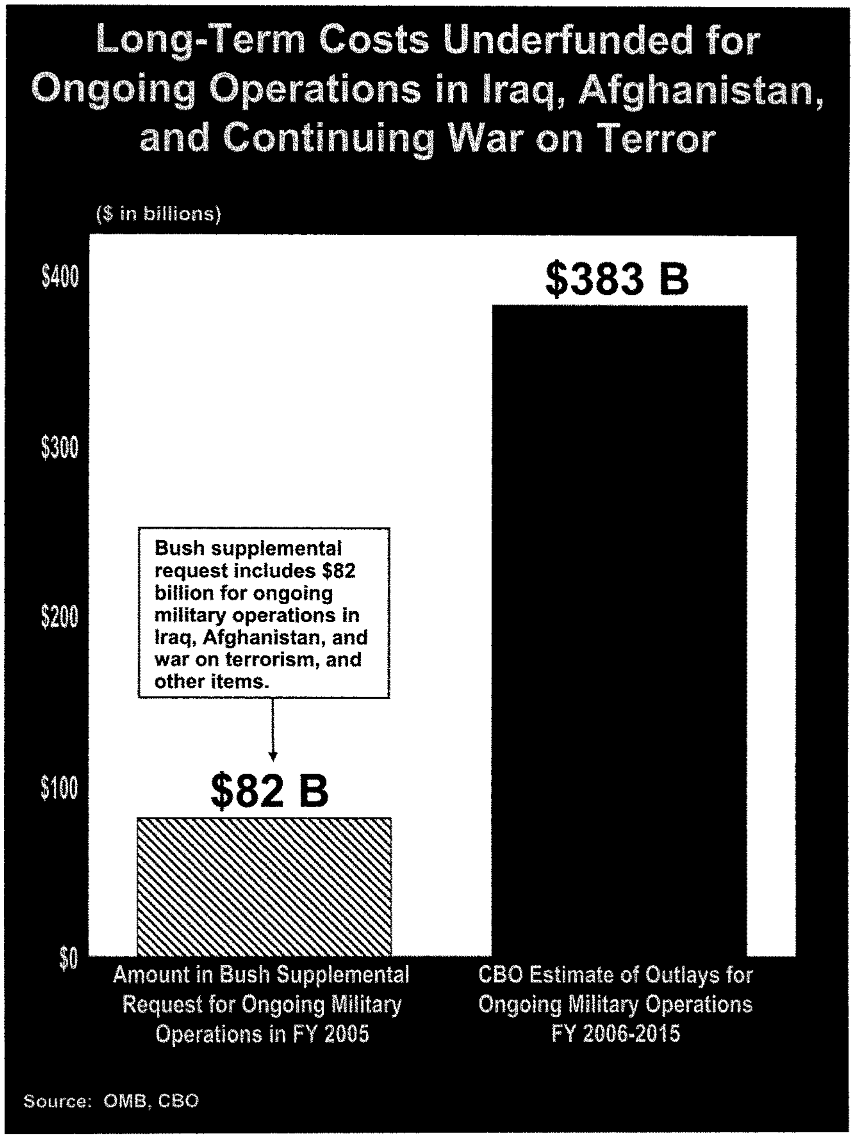
| | |
|---|---|
| STEPHANOPOULOS: | "What should the public know right now about what a war with Iraq would look like and what the cost would be?" |
| RUMSFELD: | "...The Office of Management and Budget estimated it would be something under $50 billion." |
| STEPHANOPOULOS: | "Outside estimates say up to $300 billion." |
| RUMSFELD: | "Baloney." |

— Defense Secretary Donald Rumsfeld
Interview on ABC's "This Week with George Stephanopoulos"
January 19, 2003

Let us go to the next slide. These are just the supplementals that we have had since that time. The supplemental in 2003 was 79 billion. We had a total of supplementals in 2004 of 112 billion, and now this year $82 billion. You add that all up and we are approaching the $300 billion that was described as baloney.


Bush Funds Iraq War and War on Terror
With Large Supplementals
($ in billions, budget authority)
$120
$100
$80
$60
$40
$20
$0
$79 B
$112 B
$25 B
$87 B
$82 B
2003
2004
2005
Source: OMB, CRS
Note: 2004 funding includes $25 billion FY 2005 emergency budget amendment made available immediately in FY 2004. FY 2005 number assumes enactment of $82 billion supplemental request.

Whatever the description, the harsh reality is this has cost us a lot, and it is going to cost us a lot more. As I look at the budget, I do not see the President providing for these costs anywhere close to what most objective observers say the cost is going to be. We have the supplemental now of $82 billion. The Congressional Budget Office says that the expected cost is over $380 billion. If I were to fault the administration, I would fault them for not really sharing with us in a clear way what the costs are going to be. I know people say it is hard to estimate the cost. Well, that is what a budget is about, and it is like a family saying it is hard to estimate what our utility bill is going to be, so we just leave that out of the family budget, or it is hard to estimate how much we are going to eat out so we are going to leave that out of the budget.


Long-Term Costs Underfunded for Ongoing Operations in Iraq, Afghanistan, and Continuing War on Terror
($ in billions)
$400
$300
$200
$100
$0
$383 B
Bush supplemental request includes $82 billion for ongoing military operations in Iraq, Afghanistan, and war on terrorism, and other items.
$82 B
Amount in Bush Supplemental Request for Ongoing Military Operations in FY 2005
CBO Estimate of Outlays for Ongoing Military Operations FY 2006-2015
Source: OMB, CBO

We know the right answer is not zero past September 30th of this year, and yet that is where we are with the budget. So I would urge the administration to put in the budget what they think the real costs are going to be.

Let me go to the next slide. This is a quote again from the Secretary in February 12th of 2004 before the Defense Appropriations Committee, and he said, “We have instituted realistic budgeting so that the Department now looks to emergency supplementals for unknown costs of fighting wars and not to sustain readiness as had been the practice previously.”

## Bush Administration Promised Not to Use Supplementals to Fund Core Defense Budget

**"We've instituted realistic budgeting so that the department now looks to emergency supplementals for unknown costs of fighting wars and not to sustain readiness, as had been the practice previously."**

– Donald Rumsfeld, Secretary of Defense
Testimony to House Defense
Appropriations Subcommittee
February 12, 2004

But when we look at this budget, when we look at these supplementals, we see something other than that assertion. We see $5 billion for Army modular force restructuring, $2 billion for aid to foreign militaries, $100 million for a Jordan Special Operations Training Center, $300 million for recruiting and retention, and as much as $3 billion of core Army operations and maintenance costs.

I would say to you, Mr. Secretary, and through you to the Secretary of Defense, from a budgetary standpoint I think it is critically important that we have these ongoing expenses included in the budget itself, not in supplementals, because that will lead us down a road that is even more unsustainable than our current course.

With that I look very much forward to your testimony. Mr. Secretary, you reminded me this morning we first met in Indonesia almost 20 years ago, and I was very impressed by you then. As I have expressed to you before publicly, we appreciate all of those who come forward and serve this Nation, and I say that to General Pace as well. I have high regard for Ms. Jonas, thank you as well.

Chairman GREGG. Thank you, Senator Conrad.

Dr. Wolfowitz, we would be happy to hear your thoughts.

## STATEMENT OF PAUL WOLFOWITZ, DEPUTY SECRETARY, DEPARTMENT OF DEFENSE, ACCOMPANIED BY GENERAL PETER PACE, VICE CHAIRMAN OF THE JOINT CHIEFS OF STAFF, DEPARTMENT OF DEFENSE; AND TINA JONAS, UNDER SECRETARY OF DEFENSE/COMPTROLLER, DEPARTMENT OF DEFENSE

Mr. WOLFOWITZ. Mr. Chairman, thank you. Senator Conrad, thank you.

We understand the enormous responsibility this committee has to try to look at the overall financing of the Federal budget. We appreciate that we are a very big part of, as you said, of the discretionary part of that budget, and most importantly we appreciate that the incredible men and women who serve this country so nobly and so well, that both of you have praised appropriately. And I think we cannot praise them enough, could not do what they do without the support that comes from the U.S. Congress through the budgetary process. We know that we need that support and we are privileged to come here and be able to try to explain what we are doing to this important committee. Given the many difficult choices with which you are faced, I appreciate this opportunity.

As both of you have referred to, we are a Nation at war. On September 11th, 2001, terrorists attacked the United States in a way that American territory had never been attacked before, claiming lives on a scale that could only be compared with the attack at Pearl Harbor 60 years earlier. Along with our national loss, September 11th revealed another stunning threat, the possibility of far more terrible attacks including those using weapons of mass destruction. Indeed, soon after September 11th the Congress itself was attacked with military grade anthrax.

Given the nature of terrorist networks and the secrecy with which they operate, no one can say for certain why this country has not been attacked in the last 3 years. What we can say with confidence is that the reason we have not been attacked is not because

the terrorists have not been trying, we know that they have. But we can also say with confidence that many plots and attempted attacks, both here and abroad, have been thwarted through the continuing efforts of the United States and some 90 nations who are cooperating with us in the war on terror. The facets of this international cooperation are many and varied. They are not purely military.

In fact, from our standpoint, this war involves all elements of American national power, including military force, but not solely or in most cases even primarily military force. Indeed the various instruments of our national power, including intelligence, law enforcement, diplomacy, and I would add particularly as we watch dramatic events unfolding in places like Lebanon, the power of the idea of freedom for which this country stands served to reinforce one another. But there is no question that the contribution of the U.S. military has been indispensable to much of the success that we have achieved so far.

While our efforts are far from complete, we can point to certain significant milestones. For example, terrorists have lost their ability to train thousands of potential terrorists in camps that previously existed in Afghanistan and in northern Iraq. And while bin Laden and his top lieutenant, Ayman al-Zawahiri, are still on the loose, more than three-quarters of al Qaeda's senior leaders have been detained, captured or killed, and thousands of lesser members of that organization since September 11th. Bin Laden's access to resources and his ability to communicate with his confederates has been significantly constrained. And in the terror war which bin Laden Abu Musab al-Zarqawi is waging against democracy in Iraq, al Qaeda is losing badly.

In just the last 3 years, in regions some people previously judged immune to the democratic spirit, there has been an extraordinary movement toward representative Government, what President Bush has rightly called the ultimate weapon against the terrorists' bleak vision of death and despair.

Thanks in no small part to the efforts and the sacrifices of American men and women in uniform, some 50 million people in Afghanistan and Iraq, almost all of the Muslims, are now themselves helping to advance the cause of freedom in the Muslim world.

But Afghans and Iraqis are not alone. There seems to be a larger movement of democratic forces at work, and it has been due in great measure to the courage and commitment of brave and committed citizens of Muslim countries themselves, in many cases without any involvement of U.S. military force.

Last September in the country where I first met Senator Conrad—it is hard to believe it was 20 years ago, Senator, you do not look that old; I hope I do not—Indonesia, the country with the largest Muslim population in the world, held it second successive free and fair election of a president, a milestone often considered a landmark on the road to democracy.

In January the Palestinian Authority held an historic election that has produced new leadership that may finally deliver for the Palestinian people the state they have long deserved.

In Lebanon tens of thousands of people have come out to demonstrate in the wake of the assassination of former Prime Minister

Rafiq Hariri. As we saw just yesterday, the Syrian-backed government in Lebanon resigned under popular pressure.

And of course citizens were a powerful driving force for freedom in Afghanistan and in Iraq.

While the U.S. military is not the only national instrument the has contributed to these important goals, its indispensable role is unquestionably the most expensive. It is expensive in terms of the resources that it demands of the American taxpayer, and it is expensive particularly in terms of the sacrifices that it demands of our men and women in uniform, including those who have made the ultimate sacrifice for our freedom and security.

This Defense budget is first and foremost about them and about their future, and about ours as Americans.

It is in this context, Mr. Chairman, that the President has requested $419.3 billion in discretionary budget authority for the Department of Defense, representing a 4.8 percent increase over fiscal year 2005. Combined with a supplemental, this request provides sufficient funding to sustain the President's pledges to defeat global terrorism, to restructure America's armed forces and global defense posture, to develop and field advanced war fighting capabilities, and most of all to provide for the personnel needs of our forces.

Before I discuss the 2006 budget request, I would like to say a few words about the supplemental. The President has pledged that our troops will have what they need to fight and win this war. The President's recent request for an additional $74.9 billion in fiscal year 2005 supplemental appropriations, on top of the $25 billion that was appropriated last August, keeps that solemn pledge.

Of critical importance, this supplemental will provide significant resources to address wear and tear on our military equipment, to create a larger more combat-capable Army and Marine Corps, and to train and equip Iraqi and Afghan security forces to empower them to take the fight to the extremists and help them take control of their future. Let me briefly address each of those three topics.

First, as far as resetting the force is concerned: a high operating tempo is causing significant wear and tear on some of our war-fighting equipment. The supplemental includes $11.9 billion to reset or recapitalize the force, which is essential to ensuring military readiness. I think those are some of the costs that Senator Conrad referred to, and we believe they are war related costs.

Our commitment is to keep military units at full combat strength, and provide them with the equipment they need to be ready when we need them.

Second, very importantly, when it comes to restructuring ground forces, the Department has made a major commitment to restructuring the U.S. Army, adding $35 billion over the 7-years of the fiscal year 2005 to 2011 future years Defense plan, on top of $13 billion that was already in the Army baseline budget.

Restructuring will increase the number of Army brigades and convert them into independent brigade combat teams that can conduct operations on their own. Let me take just a moment to explain in a bit more detail what we mean when we talk about that conversion. We use regularly the term "Army modularity." We all think we know what it means, but it is a kind of obscure phrase that I think obscures the exciting implications of what's going on.

Because what the Army is undertaking is actually a remarkable and fundamental transformation in the way that it organizes and thinks about deploying forces, and it will make a huge difference in the strain that is placed on forces and the strain that is placed on families through deployments.

The Department has made a major commitment to this type of restructuring for its ground forces, which is designed to add more deployable units, create a larger rotational base, and increase flexibility, thus relieving the strain on the total force by creating more deployable units.

The Active Army, for example, will expand from 33 maneuver brigades in fiscal year 2003 to 43 brigade combat teams in fiscal year 2007. The chart that has been put up actually shows you how that increase of 10 deployable brigade combat teams, if notional, for deployment of 15 active brigades, increases the amount of time that any individual brigade spends at home by 50 percent. That is a very big difference, has a very big impact on morale and on families.

In addition the current Army plan would restructure the Army National Guard to reach 34 trained and ready brigade combat teams by fiscal year 2010, up from the current 15. The most significant consequence of these two expansions is that for any required level of overseas force deployment, active brigades will deploy much less often and reserve maneuver brigades will be mobilized much less frequently.

Right now as we speak, the Army's Third Infantry Division, the first to complete the transformation going from three brigades to four independently deployable units has just completed its redeployment to Iraq. It is putting this new concept into practice. The Third Infantry division relieved the First Calvary Division which will undergo the same transformation now when it returns to Fort Hood. The result of that change in the Third Infantry Division is that we needed one less National Guard brigade to fill what otherwise would have been a hole.

The recent history of the Third Infantry Division explains why we are funding Army transformation in fiscal year 2005 and fiscal year 2006 from supplemental funds. As the Third Infantry Division redeployed from Iraq some 15 months ago, we simultaneously reset it from the wear and tear of combat and transformed it from three brigades to four.

Let me emphasize beginning in fiscal year 2007 we will request funding for restructuring I the baseline Army budget. By then we expect both the rotational strain on our troops to be less, and our understanding of the costs of transformation to be more exact.

But for this year and next year supplemental funding is critical because it addresses two urgent requirements. First it rapidly expands the operating size and combat power of the Army, making our forces more effective in the global war on terror and making their deployment more sustainable. And second, by creating a larger number of more capable brigades available for rotation, it significantly reduces the strain on our military units and troops.

Third and very important, the supplemental also funds the vital strategic goal of training and equipping indigenous military and security forces in Iraq and Afghanistan. Building the capabilities of

these countries' forces is essential to the long-term security and stability of both nations, and will enable them to become more self-sufficient and less reliant on U.S. and other coalition forces. I urge full funding of our request and creation of an Iraq Security Forces Fund and Afghanistan Security Forces Fund to provide the resources needed to train those forces so that they can take control of their own security needs and take the burden off of our troops.

Members of Iraq's security forces were critical participants in January's choice for freedom. Several bravely gave their lives to shield Iraqi voters from suicide bombers and insurgents. Their performance on the January 30th election day is visible and tangible evidence of the returns we are getting from our substantial investment in those forces.

In a recent call with General Casey, he told us that since the election Iraqi security forces have grown more confident, and volunteers have grown in numbers. The Iraqi people have become more confident of an Army made up of Iraqi patriots who are their husbands, their daughters and their sons, and some 1,400 Iraqi police and soldiers have died since Iraq's liberation.

Mr. Chairman, let me say a brief word also about the requesting in the supplemental for tsunami relief. Let me also emphasize that our ability to come to the aid of hundreds of thousands of people who were made homeless by that incredible disaster, that made it possible I think to save tens of thousands of lives, would not have been possible without the investment the American taxpayer has made over many years in those capabilities. We estimate conservatively just the equipment alone, the ships and the helicopters, represented a $28 billion investment in military equipment that no other country could have provided. It was an honor and a privilege to be able to do that, and I think it was not only a great humanitarian success, but I also think it has helped advance America's position in many parts of that region.

We have requested funds in the supplemental to cover those expenses. We have an enormous stake to make sure that the subsequent recovery efforts build on the success we have already achieved. The benefits of that assistance will focus principally on Indonesia, which, as I believe Senator Conrad pointed out, has the largest Muslim population of any country in the world, and it does so at a time when Indonesia is emerging as a democracy, seeking to join the community of free nations.

A recent poll in that country indicates that strong positive change in public opinion after people saw how Americans, especially American military men and women, labored to bring life-saving water, food and other supplies. I was privileged to visit with young sailors on board the U.S.S. Lincoln, as did several Members of Congress. They were incredibly eager and enthusiastic volunteers whose tireless and selfless efforts were truly inspiring.

We now have the opportunity—and the supplemental will enable that—to build on their wonderful work by helping Indonesia strengthen its democratic institutions and rebuild its vital infrastructure. It is certainly in our national interest to do so.

Mr. Chairman, we have had to make some difficult choices in this budget, particularly to find the resources to fund Army modularity in fiscal year 2007 and beyond. We recognize that the

fiscal year 2006 budget is sizable by historical standards, but I believe it is a sustainable defense burden, especially in light of the stakes involved. Americans can be ensured, however, that we are balancing this budget request with some difficult choices among competing needs. We need Congress's support of those tough choices.

To get the best out of America's investment in defense the budget reflects continuing work to restructure our forces, to restructure our global defense posture, and to restructure our basing here at home. We believe those are all smart choices that will help to achieve more combat power in the future without a commensurate increase in troops or funding.

Beyond concepts like Army modularity, something equally remarkable is taking place in the way in which we base our forces. We are changing fundamentally the character of our global stationing, and at the same time we are going through a major effort to realign our basing posture here at home so that it supports the essentially expeditionary character of most of our forces. In addition we think this realignment of our base structure will support the new requirements for homeland defense.

There are two key initiatives regarding base structure that I would like to mention. The President's global posture restructuring will bring home 70,000 U.S. military personnel and approximately 100,000 dependents back to the United States, and relocate those forces and equipment that remain overseas. Second, the 2005 Base Realignment and Closure Commission will take this return from overseas into account in deciding how to streamline and restructure the Department's installations here in the United States.

In addition, all of our services are taking efforts to rebalance the distribution of military specialties between the active and reserve components, so that for those military specialties that are in high demand, we will not constantly have to go to the reserves as we have had to for certain ones, particularly, notably, civil affairs.

Mr. Chairman, the fiscal year 2006 budget funds a balance combination of programs to develop and field the capabilities most needed by America's military. It provides for our most valuable asset, our people, by maintaining the President's commitment to take care of our military men and women and their families. It includes a 3.1 percent increase in military base pay. It includes an increase in funding to ensure continuing good health care, and it will fund by fiscal year 2009 the elimination of all inadequate housing units worldwide.

Mr. Chairman, American soldiers, sailors, airmen, Marines and Coast Guardsmen, as well as their civilian colleagues serving in the global war on terror have performed magnificently. They have done everything that has been asked of them and more. As of February 28th, more than 1,600 Americans have given their lives in Afghanistan and Iraq, and thousands more have been wounded to protect our freedom and encourage liberty's advance for people once enslaved by brutal tyrannies.

They could not have pursued this noble cause without the strong support of Congress. On behalf of those brave Americans who serve and have served us so well, I would like to thank the members of

this committee and the entire Congress for that continued bipartisan support.

We can point to some truly significant gains, some of which I mentioned earlier, but we must not allow ourselves to become complacent just because this country had not been attacked in the last 3 years. As I said earlier, we know that the terrorists are still actively plotting, and we must maintain strong pressure on them, and if possible, intensify it.

As just one example, I would note that in the regions that straddle the Pakistan-Afghan border, as we speak here today Pakistani armed forces, supported by active American operations on the Afghan side of the border, are putting intense pressure on al Qaeda leadership, hiding in northwest Pakistan.

But while capturing and killing terrorists is critically important, this struggle is not just about those activities alone. As the President said in his inaugural address, and I quote, "The best hope for peace in our world is the expansion of freedom in all the world." That means reaching out to mainstream Muslims who want freedom and democracy and prosperity. That is what the terrorists fear. That is why they fight to impose on their fellow Muslims a medieval, intolerant, tyrannical way of life.

That is the fear that prompted members of the Taliban to threaten voters in the Afghan elections. That is the fear of freedom and self-determination that caused Osama bin Laden to declare that Iraqis who voted in the elections would be infidels and apostates.

But we know that despite those threat, the Iraqi people exercised their new-found freedom and voted anyway. It is a story of enormous courage by 8–1/2 million individual Iraqis, every one of whom knew they were taking a personal risk when they marked their finger with that bright purple ink, telling everyone including the terrorists where they stood.

There are many stories of heroism from that day, including the stories of two separate Iraqi policemen who tackled suicide bombers and gave their lives to protect voters. But one of the ones that impressed me the most was one told to me the next day by Brigadier General Carter Ham, who commands our forces up in Mosul.

He described a polling station in a Sunni-Arab neighborhood of that city, a city that suffered some of the most brutal intimidation in the last few months. Nobody had voted for the first 2 hours, but a crowd of several hundred people had gathered at a distance to watch. Finally, around 9 o'clock in the morning after the polls had been open, as I say, for 2 hours, one old woman in her late 60's, early 70's stepped forward and said, "I have waited all my life for this opportunity. I am not going to miss it." She stepped into the polling place and the crowd followed her. The will to fight for freedom does not diminish with age or infirmity.

It is difficult to imagine people anywhere in the world showing more courage and determination to vote in the face of intimidation.

But as impressive as that result is, as impressive as the results in Afghanistan or some of the seeds of freedom that are sprouting elsewhere in the Middle East, Iraqis and everyone still face a difficult road to defeat the terrorist threat, to defeat tyrannical intimidation, and to achieve stability, much less freedom and democracy. But our investment in training Iraqis to defend themselves is be-

ginning to pay off, and it will continue to do so, especially as their growing capability translates into less stress on our troops, which is one of our key goals.

Mr. Chairman, just to conclude, our investments in many fronts of the global war on terror have given us some important returns, but we must remain resolved and patient, for there is much yet to do. This problem of terrorism grew up over a period of 20 or 30 years if not longer. It is not going to go away in two or three. We may recall how long we waged the cold war and how long it took to rebuild Western Europe, but in both cases we know how the story ended. We know that seemingly impossible challenges can be achieved when the American people and their allies are resolved to stand firm for freedom, and freedom is perhaps the most powerful force in the world.

It has been the glue of the world's strongest alliances. It has been the solvent that has dissolved tyrannical rule. The same values that held the western alliance together over four decades of often contentious debate during the cold war have brought some 40 countries into the coalition effort in Afghanistan, more than 30 countries with us into Iraq, and some 80 or 90 countries into the larger coalition against global terrorism. The longing for freedom that penetrated even the Iron Curtain brought about the peaceful end to the cold war, and that same universal desire for liberty among Muslims as well as non-Muslims will be our strongest weapon in fighting fanaticism today.

Mr. Chairman, this budget addresses our country's need to fight the war on terror, to support our men and women in uniform, and to meet the threats of the 21st century. It reflects difficult choices to ensure sufficient funding for our most pressing requirements. Those difficult choices and our proposed transformation of the business of defense underscores our resolve to be wise in spending taxpayer dollars.

This committee has provided our country strong leadership in providing for the national defense, and ensuring the taxpayer dollars are wisely spent. We appreciate that support and we look forward to continuing our work with you to achieve both of those critical goals.

Thank you very much.

Chairman GREGG. Thank you, Mr. Secretary, for that very strong statement on purposes of our military and how it has brought freedom really to millions of people and allowed elections to occur in Afghanistan and Iraq, which have led, I believe, to the elections in Palestine being successful and the recent Lebanon situation, which has reflected a movement toward democracy. So I congratulate you.

This committee deals with numbers, and although the philosophy you have presented is one I would love to pursue, because I think it needs to be echoed, let me stay with the purposes of this committee which is numbers.

The ranking member, Senator Conrad, has mentioned the fact that the budget did not, as presented by the President, did not have in it any allocation for the expenditures which we might incur relative to the war in Iraq. It had in it a core defense budget, as you mentioned, of $419 billion as being the request. You have obviously presented a supplemental this year. There are prior

supplementals before this year. It is logical that next year we will need to expend money in Iraq and in Afghanistan, which will be above the core defense budget. It would be my expectation that as part of our budget process, we would put in place a reserve fund for the purposes of funding that. I expect it would be in the same range as we put in last year, although the budget did not pass last year, which was $50 billion.

The reason I think it is important to pursue it in a reserve fund form and the reason I think you are correct in bringing up the issue of how you paid for the war in Iraq and Afghanistan through the supplemental process, as versus through the core process is that these are not expenditures which are going to go on forever. In fact, we hope that they are expenditures which will be shortened in their time horizon rather than infinite in their time horizon, and in fact, hopefully no more than two or three more years of significant expense, maybe even less if we are fortunate.

Therefore, I do not believe that these dollars that we are expending in Iraq and Afghanistan should be built into the defense base, and I think it would be a major budgeting error to do that because it would inappropriately inflate the defense base. So they should come forward as supplementals, but I also think that our budget should reflect the fact that we expect that, and therefore, I do anticipate that we will put in, as I said, a reserve fund. I have spoken with people within the administration who I do not believe resist this idea. I think they probably think it is a reasonable approach, and I would be interested in whether you even have an opinion on this or whether you think it is our responsibility to just go forward and do what we think is right.

Mr. WOLFOWITZ. Let me say we certainly want to work with you to provide as much clarity as we can about expenditures. I agree emphatically with what you have just said about why these emergency expenditures that are not predictable should not be built into the base budget. In fact I believe we made an effort to do exactly that in the first year of Operation Enduring Freedom, and I think the Congress turned it down on the ground that this would be an unallocated—in some people's words—slush fund.

I think when you have emergency expenditures of this kind that really are unpredictable, it is wise to do it through supplemental. At the same time we can absolutely predict there will be a supplemental budget request next year. I do not know what the size is. I hope as you do that it may turn out to be a lot smaller than what we need this year, but I would be a fool to predict that. I think, therefore, making some kind of a provision in your overall budgeting for the fact that there's going to be a requirement for U.S. Fiscal resources over and above the $418 billion that we are requesting makes common sense. I think you did it last year or tried to do it last year.

The one thing I would add in addition is the reason we came forward with a supplemental request for 2005 early in this process this year was precisely so that people would see—as you know, often there has been a tendency, for various reasons, to delay it and delay it. We are kind of happy as the Defense Department to get that number out there early, and I think the administration as a whole was happy to get it out there early so that Congress under-

stands at this point what we estimate is going to be the full cost for fiscal year 2005, but we really cannot predict fiscal year 2006.

Chairman GREGG. I expect we will set up a reserve fund and it will be approximately in the range of last year, and I take it from your answer that you do not have any great reservations about that approach.

The number 419 is a significant number, but in the context of being at war it is probably not a significant number relative to the rest of the national budget, the national budget being a $2.5 trillion budget. We are at war. Senator Conrad put up some numbers which reflected this in real terms relative to the number in other periods in our history, but I suspect that if we went back historically the percentage of the budget that is being committed to fight this war is significantly less than percentage of the budget that was certainly committed to fight World War II when we were attacked at Pearl Harbor as we were attacked this time in New York and here in Washington. And I suspect that it is significantly less than when we were at war in Korea, and probably in Vietnam, and during the defense buildup of the Reagan years it may have even been less then when we were not in a formal war, though obviously our intention was to dismantle the Soviet Union by making it clear to them that they could not compete with a free society.

So I would be interested in putting those numbers in a framework of what they represent rather relative to defense spending at a time of war if you have those numbers.

Mr. WOLFOWITZ. Ms. Jonas may have more detail. I know roughly just in terms of the measure of percent of GDP, which—or defense burden, or what it represents for the average taxpayer, if there is such a thing as an average taxpayer. We are at about 3.3 percent of GDP which I think is about half or less than half of the cold war peak. My impression—I guess I do not want to guess.

What was it in World War II, Tina? Do you know?

Ms. JONAS. I do not have that percentage, but I do have, in terms of Federal spending, we are 18 percent—this budget would make us 18 percent of Federal spending. But 1960 we were 51.4 percent of Federal spending so it has dropped a little bit. I have the number here. In 1960 DOD outlays were 8.2 percent of GDP, so we are down significantly.

Mr. WOLFOWITZ. We will get you the full historical data, not for the record.

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(The information follows):

| Fiscal Year | DoD Outlays as a % of: Total Federal Outlays | GDP |
|---|---|---|
| 1940 | 15.8 | 1.5 |
| 1941 | 44.0 | 5.3 |
| 1942 | 67.1 | 16.3 |
| 1943 | 79.8 | 34.8 |
| 1944 | 83.1 | 36.3 |
| 1945 | 82.5 | 34.5 |
| 1946 | 72.8 | 18.0 |
| 1947 | 38.3 | 5.7 |
| 1948 | 34.1 | 4.0 |
| 1949 | 28.9 | 4.1 |
| 1950 | 27.4 | 4.3 |
| 1951 | 43.0 | 6.1 |
| 1952 | 57.2 | 11.1 |
| 1953 | 57.0 | 11.7 |
| 1954 | 56.5 | 10.6 |
| 1955 | 51.4 | 8.9 |
| 1956 | 50.1 | 8.3 |
| 1957 | 49.8 | 8.4 |
| 1958 | 47.6 | 8.5 |
| 1959 | 45.0 | 8.5 |
| 1960 | 45.0 | 8.0 |
| 1961 | 44.3 | 8.2 |
| 1962 | 43.8 | 8.2 |
| 1963 | 43.1 | 8.0 |
| 1964 | 41.7 | 7.7 |
| 1965 | 38.8 | 6.7 |
| 1966 | 40.2 | 7.2 |
| 1967 | 42.8 | 8.3 |
| 1968 | 43.4 | 8.9 |
| 1969 | 42.4 | 8.2 |
| 1970 | 39.4 | 7.6 |
| 1971 | 35.4 | 6.9 |
| 1972 | 32.5 | 6.4 |
| 1973 | 29.8 | 5.6 |
| 1974 | 28.8 | 5.4 |
| 1975 | 25.5 | 5.4 |
| 1976 | 23.6 | 5.1 |
| 1977 | 23.4 | 4.8 |
| 1978 | 22.5 | 4.6 |
| 1979 | 22.8 | 4.6 |
| 1980 | 22.5 | 4.9 |
| 1981 | 23.0 | 5.1 |
| 1982 | 24.7 | 5.7 |
| 1983 | 25.4 | 6.0 |

| | | |
|---|---|---|
| 1984 | 25.9 | 5.7 |
| 1985 | 25.9 | 5.9 |
| 1986 | 26.8 | 6.0 |
| 1987 | 27.3 | 5.9 |
| 1988 | 26.5 | 5.6 |
| 1989 | 25.8 | 5.5 |
| 1990 | 23.1 | 5.1 |
| 1991 | 19.8 | 4.4 |
| 1992 | 20.7 | 4.6 |
| 1993 | 19.8 | 4.2 |
| 1994 | 18.4 | 3.9 |
| 1995 | 17.2 | 3.6 |
| 1996 | 16.2 | 3.3 |
| 1997 | 16.1 | 3.2 |
| 1998 | 15.5 | 3.0 |
| 1999 | 15.4 | 2.9 |
| 2000 | 15.7 | 2.9 |
| 2001 | 15.6 | 2.9 |
| 2002 | 16.6 | 3.2 |
| 2003 | 18.0 | 3.6 |
| 2004 | 19.1 | 3.8 |
| 2005 | 17.9 | 3.6 |
| 2006 | 16.5 | 3.3 |

Chairman GREGG. The point I was obviously trying to make was that, yes, we are spending a lot on defense, but we are at war, and in the context of other times that we have been at war, actually our defense spending is small compared to those periods.

Senator CONRAD.

Mr. WOLFOWITZ. One other point, Mr. Chairman, too. I think compared to the potential cost to this country if terrorism is successful—we had a inkling of that on September 11th—the potential expense of that. We are not doing this mainly to—most of all it is a matter of protecting lives and security, but just the monetary costs alone of terrorism are enormous.

Chairman GREGG. Thank you.

Senator CONRAD.

Senator CONRAD. Thank you, Mr. Chairman.

Let me say first of all the speaking for me, I intend to fully support the President's request for Defense, as I have throughout this period. We are at war. I think it is very important that we stand shoulder to shoulder. I think it is very important that we signal our adversaries that we are united in support of our men and women in uniform, and I think that it is just critically important that we send that message. I can assure you that on our side of the aisle, we will fully support the resources the President has requested.

I also told the President, when I had an opportunity to fly to North Dakota with him right after the speech on the state of the union, that I thought when he talked about the enduring values of this country, freedom, liberty, that is really the moral strength of America, and that is the signal that we should send the rest of the world.

I think I mentioned to you, Mr. Secretary, that I graduated from high school from an American military base in Libya, old Wheelus Air Force Base. A family I lived with was the Vice President of Mobil Oil in Libya at the time. His name was Wendall Smith. So it was an interesting growing up. Sometime I would love to sit down with you and share perspectives on what is happening in that part of the world and the challenge that we face there.

But we face a challenge on this committee of trying to make all this add up, and frankly, as I look at the overall budget, I do not see any of it adding up, and that is a big problem. We have record deficits. We are headed for the retirement of the baby boom generation. And the pressure on all of these spending priorities is going to be intense and only get more so.

Let me just go to this. This struck me, this exchange with the Secretary of Defense on February 7th in a press briefing on the President's budget. And let me just go over with you what was said in this briefing. The reporter asked the Secretary: "The budget shows that Army spending is going down by $300 million in the fiscal year." The Secretary interrupted and said, "Which as you know is not the case." The reporter said, "Well, that's what I see." The Secretary said, "Yeah, I should have mentioned that. The only way you can look at this budget is to look at the supplementals with it, and it would be a misunderstanding of the situation to come to the conclusion that you pretended you had come to, but of course you did not, being as knowledgeable as you are." The reporter:

"Well, are you hiding? Are they in fact hiding non-combat costs in the supplemental?" The Secretary: "No, of course not. No, that would be wrong"—laughter—"and we wouldn't do that."

You know the problem that I see looking at this budget—and again I want to make clear I support the overall resources being requested—but I have to tell you I am very, very concerned about not having anything in the budget for past September 30th of this year for conducting this war. We all know that there are going to be expenses. To the extent we know them, we ought to budget for them.

I applaud to chairman for indicating he is going to put up a reserve fund, because it is just a mistake, I believe, not to tell the American people, not to tell Congress the expenses that we anticipate associated with these conflicts. You know we can take—but we need you to make your best estimates, and I know it is hard, I know it is difficult to estimate, but it is impossible to put together a budget unless we make good faith estimates of what costs are going to be, and to say there are not going to be any costs, to suggest in a budget there are not going to be is just wrong. We know it is not the case.

So I would ask you what your reflection is on this interchange with the Secretary and the reporter on whether or not the Army budget is being reduced. How would you have answered those questions?

Mr. WOLFOWITZ. We know that the Army budget is going to—the Army resourcing in fiscal year 2006 is going to include a substantial amount for resetting the force and modularity, and I think I made that clear in my testimony. It covers expenditures that have I would say two characteristics to them. A lot, No. 1, they are unpredictable, and No. 2, a lot of them are combat related and we can get into how many angels dance on the head of a pin as to whether—certainly repairing equipment that has gone through extra wear and tear because of the very substantial increases in usage in Iraq is combat-related, but also the kind of resetting that we are doing in the Third Infantry Division on the schedule we are doing it is because we are at war. We could do it in a much more leisurely way if we were not. And these really are—that is the second point, Senator, these really are genuinely unpredictable.

General Pace may be able to help me on this, but General Shoemaker and Acting Secretary Brownlee, they first came to the Secretary of Defense with this whole idea of Army modularity—when was it, Peter? Was it the fall of last year or a little earlier?

General PACE. About that, sir, maybe just a little bit earlier.

Mr. WOLFOWITZ. That was brand new. It was projected in the neighborhood of several billion dollars. I do not want to give an exact number because my memory will betray me here. That was a brand new expenditure that had not been anticipated that is, as I say, is related to making the Army more sustainable for the war.

By the time we got around to putting together this year's supplemental just a few months later, that Army estimate had nearly tripled for a variety of reasons. So we really are dealing with something that is unpredictable, but I can predict for you with confidence that there will be a substantial request to fund Army modularity and reset in fiscal year 2006 in a supplemental appro-

priation. So if you want to take a realistic estimate of fiscal year 2006 Army resources, that would have to be part of it. And we are not trying to hide that fact. We just cannot predict it.

General PACE. If I might add, sir, when the Army thought bout how they would use the money that was coming to them to reset the force, had a choice of resetting to the old Army or moving forward to what was a new concept of modularity. Using the money then in a supplemental to buy the new Army, not the old one, and as a budget is laid out then, in fiscal year 2007 and beyond, the expenditure to reset the remaining part of the Army will in fact be on budget. But since this budget process had begun and the concept of how to modularize came up about midway through the 2006 budget process, the perturbations that would have taken place seemed to make it prudent for the Army to use the supplemental money that was available for resetting to being modularization, and then to put the rest in budget beginning in fiscal year 2007.

Mr. WOLFOWITZ. Let me just mention on the perturbations General Pace refers to, I mean we have gone through an enormous amount of reallocating budget priorities in fiscal year 2007 and beyond with in the Army and between the Army and other services, and it has led to decisions which I am sure you have read about, about scaling back procurement of aircraft, scaling back procurement of ships, efficiencies across the Department in various areas, and those involve a lot of painful decisions, a lot of moving pieces around. Trying to do that for this budget that we are presenting now with a dollar request for the Army that is uncertain, I think frankly would have thrown the whole budget process into chaos rather than help it.

Senator CONRAD. Let me just say in conclusion, I appreciate all you say. Also, we have the same problem here. I mean we have got competition for scarce resources. And frankly, it is not acceptable, I think, to come here and say, well, it is hard to predict. All of the budgets are hard to predict. That is what budgeting is, is making a projection. The one thing we know for sure is not the right answer is zero, and so I just push back and say to you it would be very useful for this committee, very useful for the Congress, if you provide estimates that are as good as you can make them about what the costs are going to be.

Chairman GREGG. I have to agree with Senator Conrad. If you can give us an approximation, we will budget it, because we are committed to making sure you have the resources you need, and it might actually be helpful to you folks in the end.

Senator BUNNING.

Senator BUNNING. Thank you, Mr. Chairman. I would like to put my opening statement into the record with your permission.

Chairman GREGG. Absolutely.

[The prepared statement of Senator Bunning follows:]

**Statement of Senator Jim Bunning**
**Budget Committee Hearing on Department of Defense Budget**
**March 1, 2005**

Thank you Mr. Chairman for holding this hearing. I'm glad to see our witnesses made it over the river and through the snow.

Mr. Chairman, this budget comes at a critical time in the war on terrorism. The military is deployed around the world. We are engaged in a fight with terrorists in Iraq and Afghanistan. We are watching closely events in Lebanon, Syria, Iran, and North Korea. Our forces are also active in relief efforts in the Pacific and keeping an eye on other potential trouble spots throughout the globe.

It is critical to our military men and women that we complete this budget and get the appropriations bills signed into law. We also have a responsibility to the taxpayers to wisely spend their money.

I am pleased that President Bush has proposed a budget that reigns in many federal programs. Even the Defense Department and Homeland Security have been asked to tighten their belts.

I also have several concerns about this budget. In particular, I am concerned that the Department is not adequately funding the chemical demilitarization efforts at Blue Grass Army Depot in Kentucky. We have a treaty obligation to destroy those weapons by 2012. More importantly we have a moral obligation to protect the citizens of our nation who live around the weapons storage sites. I think the Department needs to take a hard look at their proposal and work with me to adequately fund this program.

We also need to take a hard look at our research and procurement decisions to ensure we are preparing not only to fight terrorism, but any other threats that may arise in the future.

It looks as if the European Union is going to lift its trade restrictions on selling weapons to China. We must reevaluate our arms dealings with Europe if that proposal goes forward. We cannot allow our sensitive technologies to fall into the wrong hands and we should not reward nations that do so.

Finally, I am concerned about items requested in the recent supplemental request. Many items should not be in there, but should be in the regular budget. One item of concern is funding for Army and Marine Corps transformation. I support those efforts, but a supplemental is not the way to pay for them.

I support our troops and will do everything in my power to make sure they get the funds they need on time. We have a lot of work ahead of us, and I look forward to working with this Committee to get that process started.

Senator BUNNING. Secretary, I have before me your request for $81.9 billion in supplemental spending, and in it there is a section called International Affairs, $5.6 billion being spent. I want to know how you can justify that $200 million—I am just going the pick one out—in economic and military aid to Jordan, when Jordan was on the other side, fighting against us in the first Gulf War. My son happened to be in that war, and flying over Kuwait at the time, and we could not get Jordan's cooperation to stop the supplies coming in from Jordan. Now I want to know why, not only that, but then there is $200 million in aid to Pakistani, or to the PLO, I would suggest, humanitarian aid. I can understand that one a little better.

But these are items that are normally done in the appropriation process in Foreign Affairs. Why would they be in a supplemental?

Mr. WOLFOWITZ. There are two different numbers that come out almost the same. That is why there is a certain confusion on our side.

Senator some of this is State Department budget request, including things like construction of more secure embassies and so forth, and you would have to get a State Department witness here for that. But let me just say two things——

Senator BUNNING. The big number would be $658 million for construction of a U.S. embassy in Baghdad. That would normally come under normal funding in the State Department request.

Mr. WOLFOWITZ. Well, I don't think they anticipated when they put in their fiscal year 2005 budget request 12 months ago what the security needs would be for that embassy. But let me just say that there is one large number in there, and that was what caused the confusion. It is not the $5.6 billion you mentioned. There is $5.7 billion requested for training Iraqi and Afghan security forces, and——

Senator BUNNING. Well, I understand that.

Mr. WOLFOWITZ. You understand that, OK.

Senator BUNNING. I was there watching them being trained at the time when we thought there were 250,000 of them being trained. That is what we were told. And, unfortunately, they cut and ran during certain attacks, and we finally found out that there were about 125,000 or less that we could depend on. And I understand us trying to buildup that force. In fact, General Petraeus is a good friend.

Mr. WOLFOWITZ. A constituent, I think. From a defense perspective, I would just like to comment on Jordan and Pakistan. You are right that Jordan was an unfriendly neutral during the first Gulf War in 1991. But things have changed enormously, and they really stood up and supported us at considerable risk to themselves because they are right on the border. There is a very large Iraqi—there was a very large Saddam Hussein intelligence presence in Jordan, and yet they allowed us to base forces and many things that were helpful.

And in the case of Pakistan, again, I am not about to defend everything that government does, but as I mentioned in my testimony, their cooperation in pushing into northwest Pakistan and putting pressure on al Qaeda leadership in northwest Pakistan I believe is helping us in the global fight on terrorism. And President

Musharraf has taken some enormous risks to be on our side. In fact, there have been two attempts on his life. I think support——

Senator BUNNING. I understand Pakistan better than I do some of the others.

Mr. WOLFOWITZ. OK. I cannot go line by line with you, but——

Senator BUNNING. Well, that is what we have to do.

Mr. WOLFOWITZ. I understand that, and I think for the State Department—I will do my best on the defense pieces, but——

Senator BUNNING. OK. I am going to do something that is usually done here a lot more. This is a parochial interest in Kentucky. You have withdrawn defense money for the construction and procurement of the destruction of chemical weapons at the Bluegrass Army Depot and at Pueblo, Colorado. Instead, $33 million is requested for further research. Do you know how long we have been researching the destruction of those weapons? We have a treaty to get rid of them by 2012, and even the money we appropriated in the last DOD budgets over the last 1, 2, 3 years, you want to use it for other purposes now. That is what you have requested in this year's DOD budget.

Now, go down to Richmond, Kentucky, and Lexington, Kentucky, and tell those people that those 50,000 rockets that have nerve gas, that are corroding, that you are not going to be able to get rid of them in time to meet the treaty obligations. Thirty-three million dollars is peanuts in a defense budget.

Now, why would you do that?

Mr. WOLFOWITZ. Senator, I don't want to—on the why, we were confronted with, as I think you know, enormously escalating costs for this whole program. The budget does contain $1.4 billion for this fiscal year and $6.3 billion over the course of the defense program. I talked with a couple of your colleagues about that decision, and we are certainly prepared to look at whether changes can be made. We understand the priority that has to be put into getting rid of this stuff, but we also have a problem of costs that are just going through the roof.

Senator BUNNING. I would invite you to come with me to the Bluegrass Army Depot and walk through it.

Mr. WOLFOWITZ. I would be happy to do that, sir.

Senator BUNNING. And you would understand how urgent it is to get rid of those things.

Mr. WOLFOWITZ. OK.

Senator BUNNING. Properly.

Mr. WOLFOWITZ. Let's do that.

Senator BUNNING. Thank you.

Chairman GREGG. Senator Stabenow.

Senator STABENOW. Thank you, and welcome, Deputy Secretary. I appreciate your being here. And, General Pace and Ms. Jonas, thank you for your service as well.

First, a comment, and then a couple of questions in a different direction. I would share, first of all, the sentiments of Senator Conrad speaking about the fact that we join together, Democrats and Republicans, in supporting our troops and making sure that they have the resources that they need. That will not be a debate, I do not believe, before this committee, and that is something that we all stand here ready to do.

The challenge for us goes to the question of funding the wars and whether or not it is in the budget or not in the budget, and as has been said, we know that proceeding it is not zero. And so I would just echo, Mr. Chairman, that we need to have, whether it is a reserve fund that is adequately addressed in terms of the dollars or whether it is in the regular budget. We know it is not zero. And it seems to me the supplemental should be used to make adjustments, not be a part of the regular budgeting process. So I hope in some way as a part of the Budget Committee that we will be addressing that so that this is a more real and a more honest reflection of the costs.

We talk a lot about the sacrifice our men and women make in the military, and I certainly agree with all that has been said. Deputy Secretary, you said that our men and women have done everything that has been asked of them and more. I would like to speak about what we are doing for them.

My husband and I have had an opportunity to visit the men and women at Walter Reed. He is former Air Force and International Guard, by the way. I am very proud of that. And I have also had the opportunity to have a number of men and women from the Guard and Reserve come here to the Hill and visit with me and so on, and we have worked with them.

And I am very concerned right now that for the men and women that we have been visiting with that have received medical care for injuries while serving in the war on terrorism, that without exception—without exception—the Army has made mistakes in the proper allocation of their pay. And it has been extremely difficult for them to resolve these issues, and this is of great concern to me. And I am sure it is—hopefully it is with you as well, that we are asking them to serve, they are coming back, they have injuries, and then we are dealing with bureaucracy and the inability to be able to have them receive the pay that they have earned.

Just this month, the Government Accounting Office released a report that I am sure you are aware of that found that the Army cannot "provide reasonable assurance that injured and ill reserve component soldiers receive the pay and benefits to which they are entitled without interruption."

This is just not acceptable, and I would hope that you would view it as not acceptable as well, that when we are asking men and women to serve, to fight for the freedoms that you have eloquently spoken about today, that they are not able to be assured that something as basic as their pay will be taken care of when they are injured in the line of duty. And I would like to know what funds are in the budget, this budget. What funds are you allocating to resolve these pay issues? And what plans do you have to fix this problem?

Mr. WOLFOWITZ. Those are very important questions, and I appreciate your asking them, and let me make one aside before I go to the heart of it, because Senator Conrad said correctly—and I applaud him—that it is very important for our adversaries to understand that we are united. And I just wanted to add it is also very important for our men and women in uniform to understand that.

I think I continue to be amazed, in many, many visits with our wounded troops, at the incredible spirit and morale they have in facing what, as you obviously have observed, are huge new chal-

lenges in life. And a huge part of what keeps them going is the knowledge that the country regards them as heroes.

Now, I am about to talk about material issues, which are very important, but that spiritual morale issue is—it is pretty difficult to exaggerate how important that is. So I just wanted to mention that.

I share very strongly your concern. I spend a lot of time with wounded soldiers, and I hear about some of these problems. And I cannot help saying that, you know, they get the absolute best, 21st century medical care, and then they have to deal with a bureaucracy that is inherited from earlier times.

Some of it is, I think, bureaucratic rules that probably date back to World War II when we had hundreds of thousands of severely injured soldiers for whom very little could be done, as opposed to now when the number is much smaller and the possibilities of reemployment and rehabilitation are incredible. In fact, on the good-news side, there is an Air Force lieutenant colonel who has lost his leg above the knee, not a combat injury, but he spends a lot of time at Walter Reed himself. He is the first pilot in Air Force history to be requalified on jets after losing his above the knee.

There are a lot of miracles even in the bureaucracy of that kind, but we need to do a lot better. That is the reason why we recently opened something called the Military Severely Injured Joint Support Operation Center. I think we need a shorter name for it, but this is a 24/7 family and wounded service member support center where people can call in 24 hours a day to get what we hope will be the right answers to what the rules permit, and also to alert us, if it looks as though the rules are not written the right way.

Sometimes it is a matter, unfortunately, that they will go to someone who misinforms them about what their rights are and they don't know where to go next or they accept that as the right answer, and that should not happen. So we want people who are absolutely the best trained, who know exactly what is possible, who also can alert us if what is possible is not good enough.

One of the most concerning problems to me right now is the one you alluded to, that if someone is medically retired, there is an unfortunate and I think inexcusable gap between the time they go off active duty pay and go onto VA benefit pay. And, in fact, I have talked to Jim Nicholson personally about the fact that we need to get together between our two Departments and find a way so that that burden is not borne by the serviceman, that somehow we manage to deal with it between our two Departments.

I wish I could put a deadline on when we solve it. As far as I am concerned, I wish we had solved it last month. But we are putting a lot of energy into it.

I think the general principle here is that because of the nature of modern war, the burdens of war are not distributed evenly at all across the population. It is a much smaller number of people that go into combat, that bear the costs of combat. I think that puts a greater obligation on the rest of us to make sure that those who are wounded, the families who survive members who were killed, make sure that those people who bear the inordinate burden are adequately supported by the rest of us.

I feel very strongly about it. I appreciate your interest. And I am quite certain that where money is needed to deal with that, the Congress will be supportive. I hope also where new legislation is required, I am sure the Congress will be supportive as well.

I would make one last observation, and that is, we need to be a little bit careful I think sometimes about taking a benefit that we want to go to those people who have suffered in combat and extending it to the entire population of active and retired military personnel. You very quickly sort of price yourself out of the ability to do anything. I think the point I just made is that the exceptional burdens are borne by relatively few people, and that really should make it possible to make the resources that we need to meet those needs.

Chairman GREGG. Thank you, Senator.

Senator STABENOW. Well, thank you, and if I might just conclude and just indicate that my specific question regarding funds allocated to resolve the pay issues I would appreciate a followup on to know if there are specific dollars in here, and just say that we have got a lot of work to do on this front because we do have men and women with tremendous patriotism and love for this country who have, in fact, put their lives on the line and are coming back now. And when I look at the kinds of requests I have gotten in my office on just basic things in terms of pay, it is just not acceptable and it needs to be a very high priority. And I appreciate your comments about that. But this needs to be a high priority if we expect people to believe and trust what we are saying in terms of fulfilling our commitments when they are certainly fulfilling theirs.

Mr. WOLFOWITZ. I agree with you, Senator. I take it very personally. I know General Pace does, too. Do you want to add to this, Peter.

General PACE. I know the light is red, Mr. Chairman. Please forgive me.

Chairman GREGG. Go ahead, General.

General PACE. But I would be remiss if I did not add my sincere thanks on behalf of all of us who wear the uniform, not only from the funding standpoint but the fact that so many members of this committee and of Congress go out and visit the troops, that you visit the hospitals, that you have them in your offices, that you have them in your homes. That sends a huge message to all of us, especially those who are overseas serving right now, that this Congress cares. And, Senator, you are right. It is not acceptable that any of our service members have pay problems, and we owe them better than that, and we will work on that.

Chairman GREGG. Senator Alexander.

Senator ALEXANDER. Thank you, Mr. Chairman.

Thanks to each of you for being here and thank you for your service. I would like to get an update about armor on vehicles in the combat zone in Iraq. One of our Tennessee guardsman from the 278th Cavalry Division last December got pretty famous asking the question of the Secretary of Defense, and the question went along the lines of why was he and his colleagues having to scrounge through junkyards—I believe those were roughly the words—in order to properly arm their vehicles.

That struck a chord with a lot of people in Tennessee. We prize and honor all of our service men and women, but the 278th is our largest National Guard unit. There are 3,000 of them. They had just arrived in Iraq. There are three deputy sheriffs from my home county and the school superintendent from Athens and the mayor of Lexington. So we know them all, and they are all in our community, and their lives have been interrupted for 18 months, which they are proud to do.

You have been good about keeping me updated about the progress you have been making toward making sure that they have armor for those vehicles. So my specific question is this: I have been told that by 2005 June, June of this year, just a few months away, that all of the vehicles in the combat zone will have Level 1 or 2 armor. And I wonder if we are still on that track and if you could describe for me what that means and tell me what I should be saying to families of those 3,000 guardsmen about the level of armor on vehicles in the combat zone in Iraq.

General PACE. Senator, thank you. I can respond to that. And you are correct, by the summer of 2005 we will have all our vehicles with the Level 1, Level 2 armor. You have through funding allowed us to ramp up from building, for example, 35 up-armored Humvees per month to 450 per month now, going to 550 a month in about a month and a half from now. You have given us the money we need to give every single soldier, sailor, airman, marine, U.S. Government civilian complete SAPI-protected body armor. We were able to ramp up the focus on Level 3 armor, which, as you know, is armor which is produced here but put on over there, so that by the middle of February, February 15th, General Casey, the command on the ground over there, was able to announce that no vehicles would leave and travel throughout Iraq unless they were properly armored. So he had gotten to the point where he could ensure that he could put out that kind of an order. Of the 35,000 wheeled vehicles that are in Iraq right now, 28,000 are currently protected by armor; the other 7,000 are being worked on.

So the whole program and the billions of dollars that Congress has allocated and the focus of effort to include taking sailors who are welders on ships and getting them over to Kuwait to help put on this armor has had a tremendous impact.

Senator ALEXANDER. General, that is a very good answer and an adequate answer for me. But if I were explaining in plain English to families in Tennessee what does Level 1 and Level 2 armor mean on a vehicle, what would you suggest I say? How do I explain that so they will understand it?

General PACE. You can tell Mom Pace that her son, Peter, will be protected from rifle fire in the vehicle that he is traveling in and that some of the explosive devices, he will be protected from that as well.

The difference between Level 1 and Level 2 is only where it is put on. Level 1 is made here in the United States, and it is made a part of the vehicle when it is being produced. Level 2 is the exact same armor shipped to the theater and then put on in-theater. It would be like putting a stereo in your car either bought in the factory when it is delivered to you or taking the same stereo and putting it in when you get the car.

Senator ALEXANDER. And no Level 3, which was improvising, which was finding scrap metal and using it to make a vehicle that was not properly armored better armored. Is that correct?

General PACE. Level 3 in the way it has been describes makes it sounds like the Beverly Hillbillies, which it is not. It was very good, protective armor, but, in fact, it was metal that was available in-theater that had been in-theater for other reasons and was used to properly armor vehicles to the metal protection of rifles.

What was not part of Level 3 was ballistic glass protection that is part of Level 1 and Level 2. That is correct, sir.

Senator ALEXANDER. Thank you, Mr. Chairman.

Chairman GREGG. Thank you, Senator.

Senator Feingold.

Senator FEINGOLD. Thanks, Mr. Chairman. Mr. Secretary, good to see you again.

There are Wisconsin Guard and Reserve units returning from Iraq without any of their equipment, including the Army Reserve 652nd Engineer Company from Ellsworth, Wisconsin, and the Wisconsin Army National Guard's 264th Engineer Group out of Chippewa Falls, Wisconsin. There is no way for these and many other Guard and Reserve units throughout the country in similar situations to train and maintain their readiness or be ready for state missions without their equipment. So this is also going to have a corrosive effect on morale and retention if we treat these brave citizen soldiers as second class.

The supplemental includes $5.4 billion for refurbishing and replacing equipment, but there are estimates out there that it will take much more than that. How much of the regular fiscal year 2006 budget and how much from the fiscal year 2005 supplemental is going directly to the National Guard and the Reserve for reset costs? And will that cover the need to make sure that readiness is maintained?

Mr. WOLFOWITZ. In the budget, in the supplemental request, we include funding for returning Guard and Reserve units to be reset to war fighting standard, which I believe would cover the Guard units that you are describing, although I would want to check and give you an answer for the record to be sure about that. And I think—Tina, how much is that sum?

Ms. JONAS. We have about $3.3 billion in the supplemental for reset activities. Also, the modularity piece in the baseline budget in the outyears, if the Army continues with their plan, would cover some of those units.

Senator FEINGOLD. I would like to send a letter to you, if I could, a question to just kind of nail this down a little more specifically so I can give the kind of reassurance that you at least were beginning to give me here that this will be taken care of.

General PACE. Senator, I may be able to help just a little bit, if I may; that is, part of the reason that they are coming home without their equipment is that to save taxpayer dollars, rather than have Unit A go over with the same gear that is there, Unit B is leaving their equipment behind. When they come back to the States, then we have to redistribute. That does not overcome the fact that as we started out into this with our Guard and Reserve, the plan for the Guard and Reserve had been to go as part of World

War III, so to speak, to be available to fight at month six or month nine, so the levels to which they had been provided equipment were lower than the rest of the Army.

That clearly has changed in the way we are using our Guard and Reserve. They are fabulous soldiers. They are doing a great job. And we will get the exact number for you, but I know there is $16 billion total in the supplemental for procurement and resetting the force, and the Army's intention, I know for a fact, is that as they reset the active Army, they will reset the Reserve so that it will have 43 active brigades and 34 Guard and Reserve brigades that are ready to go to combat tomorrow for the country, sir.

Senator FEINGOLD. I appreciate it, General. I will follow this closely, but I certainly sense your sincere desire to make sure there is no gap here.

The Defense Appropriations Act for Fiscal Year 2005 included a sense of the Senate that said that ongoing costs for operations in Iraq and Afghanistan should be included in the President's annual budget submission. Section 9012 of that same bill required the President to provide Congress by January 1 of this year with a detailed report on estimated costs for ongoing operations and reconstruction costs for Iraq and Afghanistan for fiscal year 2006 through fiscal year 2011.

Where is this report, Mr. Secretary?

Mr. WOLFOWITZ. We are working now with OMB and with the NSC to try to find the correct way ahead on that report. It is still not possible to accurately estimate the cost for military operations in fiscal year 2006, much less over the following 5 years. So there is a challenge here. I mean, we can make guesses, but the guesses would be really unsubstantiated.

We are working with NSC and OMB to try to answer that requirement.

Senator FEINGOLD. When will we get the report?

Mr. WOLFOWITZ. As soon as we can figure out how to answer it, sir.

Senator FEINGOLD. Estimate, please?

Mr. WOLFOWITZ. I don't have one. I am sorry.

Senator FEINGOLD. Weeks?

Mr. WOLFOWITZ. I just don't know.

Senator FEINGOLD. Years?

Mr. WOLFOWITZ. Obviously sooner than that.

Senator FEINGOLD. It is a congressionally mandated report, I would note for the record.

I am also concerned that the reliance on supplemental spending bills is forcing the services to raid accounts to cover the incremental costs of ongoing operations and, thus, hurting readiness. How much money has been reprogrammed already to cover costs in fiscal year 2005?

Mr. WOLFOWITZ. Tina, do you know?

Ms. JONAS. Sir, we could certainly provide the exact number of the record, but I would say that with our fiscal year 2006 budget, our operation and maintenance accounts are up $11 billion over the fiscal year 2005 enacted level. The readiness-related amounts are up $4 billion. So we understand the concerns of the Congress with

respect to readiness and agree that that is an important thing for the military.

Senator FEINGOLD. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

General PACE. If I might add, sir, the bridge $25 billion that you made available to us made it possible to really reduce any O&M movement into the current year. So that was very, very helpful to have that going into this year, sir.

Chairman GREGG. Thank you.

Senator Allard.

Senator ALLARD. Thank you, Mr. Chairman. I for one want to take time right at the start here to compliment our men and women of the armed forces. I just think they are doing a tremendous job. I visited with them before they went over to Iraq and Afghanistan, visited them in those countries personally, and I have visited with them when they have come back. And I think we can be very proud of our young people who have stepped forward to meet the causes of freedom. And I realize that it is a stress on their families and their spouses as well, but I think we can be particularly proud of the whole unit—the family, the spouses, and the men and women who have served in the armed forces.

I would also say this about this administration: I think you have been responsible. I have witnesses in previous conflicts and war where we have tried to run the war out of the Pentagon or you try and run a war based on politics. And I think this administration has tried to be very sensitive to the professional men and women in the military and listened to the commanders in the field. And I think that that is as responsible as you can be.

Now, you cannot come up—I can understand why you cannot come up with a sound budget, you know, specific figures on a budget. You know, war is unpredictable. I think we all have to recognize that. And, you know, there has been some unpredictable things in this budget. But the important thing is that we have responded when those unpredictable things have occurred, and I think it has been through the professional advice of those people that are in the field. They have come back with recommendations. It is then worked through, and finally we have come up with a solution.

So I do think that this has been a rather responsible budget in many ways. There are some areas obviously where we raise questions. But I don't think the administration can take all the blame because I think in being responsible and consulting with the professionals, we have dealt with four amendments on the floor of the Senate, for example, and in the House from the other side that have said, well, you are not doing enough, we need more after 9/11, we need more for our Reserves and National Guard, and we need more for our ground troops, we need more for our retirees, we need more for education after they graduate, we need more recruits, we need more intelligence, and more and more and more. But I think the bottom line is that you have been responsible.

Now, I have a lot of concern like the chairman does about how we define emergency spending. I want to compliment the chairman for thinking about how you are going to put in a reserve fund. But even with the reserve fund, I don't know how you meet all the unpredictabilities that will happen when you are in conflict. And

so my question, as we get to this budget, and particularly when you get to the supplemental, how much of this supplemental is a one-time expenditure? I think that is the key question. If it is not a one-time expenditure, then perhaps we ought to build this into the base so we can project for future expenses. But if it is a one-time expenditure, then I don't think we want to unnecessarily build this into the base and obligate ourselves into an expanding base when it is a one-time expenditure. I would like to know—and maybe you cannot give that to me today, but I would like to know how much of this supplemental is a one-time expenditure.

Mr. WOLFOWITZ. I think, if I understand the way you use the word, I think everything that we are putting in the supplemental and anticipating next year's supplemental are one-time expenditures. I know precisely we want to avoid the phenomenon you describe where we artificially inflate the base, and then you spend a long time arguing that number down because people say, you are decreasing your budget from last year, and we try to say, no, that was a one-time expenditure; it needs to come out. I think it is important to identify these expenditures, which does not mean they will not be repeated. If we are still—at some point we may still have forces—we will certainly have forces in Iraq in fiscal year 2006, for example. So spending some money this year for those forces I would consider a one-time expenditures, but we are going to have another one-time expenditure next year.

It is when we get to the point where there is some stability and some predictability to it that then you can build it into your base budget.

Senator ALLARD. Your hope is that what you are asking for in the supplemental, you may have to repeat a little bit of those requests in future years but at some point in time that is going to phaseout. If it does not phaseout, it is going to be built into the base. Have I got that right?

Mr. WOLFOWITZ. That is right, and we certainly expect at some point, and it is an unpredictable point——

Senator ALLARD. I want to move on a little bit here, and I am sorry to interrupt you on this, but I also want to followup on some of the concerns that were expressed by Senator Bunning from Kentucky. He also alluded to the plant that we have in Colorado, the problems, and that has to do with the Department of Defense's chemical weapons demilitarization program. Now the Department of Defense has decided to delay construction of disposal sites in Pueblo as well as Bluegrass in Kentucky.

My question is, is the Department considering its decision to suspend all construction activities at the disposal sites in Colorado and Kentucky? Do you know that?

Mr. WOLFOWITZ. We are taking another look at that whole decision to see whether there is maybe a different way, but there is no question that the costs, as I said, were going through the roof and we need to do something about that.

Senator ALLARD. I think you need to review costs. But here is what has happened. The Army has gone and sat down, at least in Colorado, with the leaders of the community and said, here is some technology we think is reasonable that can be done, and now all of a sudden after working this out you have backed off, or the

Army has backed off. So then this adds to the confusion of the project, adds to delays, and part of the delay is that you are asking for more studies. We have already done three studies on transportation issues out of there.

I do not understand why you include part of your restudying transportation issues related to that when you have already done three studies on that. We have in fact passed legislation that says transportation is off the table. The legislation says that if it is going to go across State lines that it has to have the agreement of the Governor as well as the President—has to go to the Presidential level, and none of that has happened. So as far as I can tell it is off the table and yet we are still going ahead and have these included in the studies.

So it seems to me that some of the costs that have gone here is because of the faults in the demilitarization program itself and it not being focused and moving forward like it should. I would hope that you would sit down, because Condoleezza Rice—I asked her this same question about how it was going to impact our relationship with other countries when we do not comply with demilitarization agreements. It is a chemical convention agreement treaty—why we did not comply with that.

Her response was, I think, very straightforward and unequivocal, that such a failure would damage our credibility overseas and hinder our efforts to hold other nations accountable when we do not meet our deadlines when we have eight sites and we are only meeting the deadline on six of them. So I do think that whole program needs to be reviewed.

I also think that the people of Pueblo and Bluegrass have been misled, assuming that you have put everything together and then all of a sudden we are back to a study. I think that the whole program, something needs to be done and we need to move forward, and what is happening now is we are just having further delays, we are going to lose confidence with our allies and our friends overseas because we are not meeting deadlines, and we need to move forward in my view. I think some of the costs that we are experiencing is because we have had these delays. Maybe you would like to have some response, Doctor, or maybe Ms. Jonas, your staff person, would want to respond to that.

Mr. WOLFOWITZ. Let me just say I think we do need to take a look at it. I think of the parameters that has to be in there though is how to contain costs, in addition to all the others. That is what led to the current budget proposal. I acknowledge there are some issues there that we really do need to look at, and would be happy to work with you and with Senator Bunning and other concerned members.

Senator ALLARD. I hope that we can. We have been working with those that are underneath you. I hope they have been consulting with you. But we do need to get something moving here. I want to make that point.

Thank you, Mr. Chairman.

Mr. WOLFOWITZ. If I may, Mr. Chairman, I think it is important at least to say for the record that the costs we carry for the cost of the war to date, for Operation Noble Eagle, which is defense of the United States, Operation Enduring Freedom, which is Afghani-

stan, and Operation Iraqi Freedom, all three put together to date is $172 billion. You can get to different numbers depending on whether you look at money that is spent or money that has been authorized. Of that $172 billion, $110 billion is for Operation Iraqi Freedom.

I think those are, Senator Conrad, different from your numbers and I would be happy to talk with you and see whose numbers are right, or maybe there is a third set. But I thought it was important to put those in the record.

Chairman GREGG. I think Senator Conrad's numbers are accurate as a statement of what the supplemental requests have been over this period—a percentage of those supplementals went to items that are not included in the three wars, that we are pursuing. So that is where the differenece probably occurs.

Mr. WOLFOWITZ. I think so.

Chairman GREGG. Senator Ensign.

Senator ENSIGN. Thank you, Mr. Chairman.

Mr. Secretary, I would like to address, the recent supplemental submitted by the Administration. One of the reasons that some of us on this committee have had a problem with the way that this supplemental has been put together is because of our experience up here on the Hill. My question focuses on how Congress has used offsets in the past for supplementals. Sometimes you have offsets for regular appropriations bills. There are real offsets and then there are phony offsets.

What I mean by a phony offset is this: DoD puts in a request for this year, including money that cannot be spent this year, or maybe even for next year. Then somebody on Capitol Hill decides, because that money is not going to be spent this year, we will rescind supplemental money and use that as an offset to make it look like regular appropriations bills are deficit neutral, when it really is not. So Congress can increase overall spending by using phony offsets.

I can understand the 2005 and somewhat the 2006 numbers in the supplemental because of what Secretary Rumsfeld explained last week to the Armed Services Committee about the budgeting process. I understand the difficulty in the budgeting process because of how long it takes to put a budget together, and how long it takes to go through the whole process, and that the supplemental is much faster. So I understand that a supplemental request in the short term, 2005 maybe and even 2006 expenditures. Which amounts to about $62.5 billion of the total supplemental request.

But after that the supplemental has $14 billion in 2007, almost $4 billion in 2008, $1.3 billion and it goes a little bit down each year from that.

I guess the question is, why those are put into a supplemental. Supplementals are supposed to be for emergencies. That is why they are designated emergency as such.

Ms. JONAS. Senator, I appreciate your concern with regard to the spending. The procurement funds are multi-year funds, but I am told that we expect that all the procurement funds would be on contract by the end of the fiscal year. The funds for the Iraqi security force, I believe, are multi-year, and that is to allow the military

to have some flexibility with their training. So I understand the concern there. But what I am told on the procurement funds, about $16.1 billion in the supplemental would be able to be on contract by the end of the year.

Senator ENSIGN. But the money is still not spent. It is going to be out there. It is not an outlay.

Mr. WOLFOWITZ. But it is a commitment you have to make in this fiscal year. Can we get back to you for the record if there is money that is not committed by the end of this fiscal year, which sounds like it may be——

Senator ENSIGN. Do you understand the fear that I have? It is that the unspent money will later be used by somebody to increase the overall budget number, to increase the deficit. They will say, "but this money was put out there in the supplemental but now it really was not spent this year so we can use that number," because even if it might be committed in contracts they will say, "Congress can now use that number since it was not an outlay." And Congress will use that as an offset and we will have to later reappropriate that money. We spent it twice.

Mr. WOLFOWITZ. I do understand your question. Let us give you a detailed answer for the record. The FY 2005 emergency supplement request for contingency operations is specifically for incremental costs above the baseline funding needed for the ongoing global war on terrorism. The supplemental request does not in any way add to the baseline funding requirement in a future year. Regarding multiyear funding, only items that are executable for obligation in FY 2005 were considered, and those must be able to produce deliveries prior to FY 2006 funded deliveries. Assuming approval of normal periods of availability for procurement appropriations, normal outlays will occur over the period of deliveries. In this respect, the supplemental funding request only supports items needed due to the emergency nature of ongoing operations, and there is no artificial expansion of a future year funding requirement base.

Senator ENSIGN. Thank you.

Thank you, Mr. Chairman.

Chairman GREGG. Thank you. We appreciate your time, Mr. Secretary. Senator Conrad did have one final question and then we are going to let you go.

Senator CONRAD. This goes to the question that was asked previously about the armoring of vehicles. General Pace, you gave a review there. I do not know what it related to; perhaps Humvees, other vehicles as well.

But here is the question that I have. It relates to the medium and heavy trucks that are in Iraq. These are the oldest trucks in the inventory. We were advised there were 9,000 of the M–939 class and the M–915 class in January in Iraq but that only 10 of them had level two armor. At that point the DoD had not even let a contract to design more robust kits, and the best that these trucks had were level three armor. I will tell you, my units that are in Iraq refer to level three armor as hillbilly armor. This is how they describe it in their e-mails to us.

These older vehicles are concentrated in the Guard and Reserve. I have got a lot of my guys who are driving these trucks, and they

are very concerned about the lack of armor. Can you tell me if those numbers that I have just used are correct, and if not, how they are not correct? We were told in January, 9,000 trucks in the theater, in Iraq specifically, and only 10 of them had level two armor.

General PACE. Senator, I will get for you for the record a very detailed description of each vehicle, how many, and by when they will have what level of armor. For today, if I may, I will tell you that as of 15 February no vehicle traveling on the roads in Iraq is allowed to be out there without level one, two, or three armor, and that the difference between one and two is where the armor was put on. And the difference between one, two, and three is that one and two have ballistic protection for the windshields themselves.

Senator CONRAD. But let me just be clear on what you have said here now because I hear that differently than what I heard before. What I hear you saying now is that as of February 15 no vehicles are on the road unless they have got one, two, or three.

General PACE. That is correct. In answer to the Senators question, by June of this year, June, July of this year, it is projected that all vehicles will have one or two. But as of now, all those traveling on the roads have one, two or three. Of the 35,000 vehicles that are there, 28,000 have one, two or three, which leaves 7,000 still to go. Then all those that have level three need to be replaced.

Senator CONRAD. From what I hear, that would still leave the possibility that there are literally thousands of these trucks that do not have one or two.

General PACE. Sir, I will get you the specific answer so we are not talking past each other.

Senator CONRAD. That do not have one or two. I want to be very clear now. That there are thousands of these trucks that do not have one or two level armor.

General PACE. I do not know that it is thousands. I do know that there are a number that have level three right now, and that by this summer all of those are to be replaced. I will get you the specifics.

Senator CONRAD. If you can get me the disposition of these, because we have got, disproportionally, Guard and Reserve driving these trucks. I was told in January there were 9,000 in Iraq and only 10 of them had one or two level armor.

General PACE. I will get you the details, sir.

Senator CONRAD. Thank you.

Chairman GREGG. Thank you. We want to thank you very much for participating in this hearing and making yourselves available to the Budget Committee. We appreciate it. We hope it will be a precedent that has been set that will continue. We appreciate your excellent presentation today. Thank you for your service to the country.

Mr. WOLFOWITZ. Thank you again and all of your colleagues for the support you give to our military. Thank you.

[The prepared statement of Mr. Wolfowitz follows:]

# TESTIMONY OF DEPUTY SECRETARY OF DEFENSE PAUL WOLFOWITZ PREPARED FOR THE SENATE BUDGET COMMITTEE 2006 DEFENSE BUDGET REQUEST MARCH 1, 2005

Mr. Chairman and Members of the Committee: Given the many difficult choices with which you are faced, I appreciate the opportunity to appear before this Committee to help you in your task by addressing the FY 2006 defense budget.

We are a nation at war. On September 11th, 2001, terrorists attacked this country in a way that American territory had never been attacked before, claiming lives on a scale that could only be compared with the devastation wrought at Pearl Harbor 60 years before. Along with our national loss, September 11th revealed another stunning threat: the possibility of far more terrible attacks, including those using weapons of mass destruction. Indeed, soon after September 11th, the U.S. Congress itself was attacked with military-grade anthrax.

Given the nature of terrorist networks and the secrecy with which they operate, no one can say for certain why America has not been attacked again in the last three years. What we can say with confidence is that the reason we have not been attacked again is not because terrorists haven't been trying. We know they have. But, we can also say with confidence that many plots and attempted attacks, both here and abroad, have been thwarted because of the continuing efforts of the United States and some 90 nations who are cooperating with us in the war on terrorism. The facets of this international cooperation are many and varied.

From a U.S. standpoint, this war involves all elements of America's power, including military force, but not solely or even primarily military force. Indeed, the various instruments of our national power, including intelligence, law enforcement and diplomacy, for example, serve to reinforce one another. But the contribution of the U.S. military has been indispensable to successes we have achieved so far.

While our efforts are still far from complete, we can point to certain significant milestones. For example, terrorists have lost their ability to train thousands of potential terrorists in camps that previously existed in Afghanistan and in northern Iraq. And while bin Laden and his top lieutenant Zawahiri are still on the loose, more than three-quarters of al Qaeda's key members and associates have been detained, captured or killed since September 11th. Bin Laden's access to resources and his ability to communicate with his confederates have been significantly constrained. And in the terror war which Bin Laden associate Abu Musab al-Zarqawi is waging against democracy in Iraq, al Qaeda is losing badly. Bin Laden also declared war on the recent Iraqi elections and warned that people who voted in the elections would be considered infidels deserving

slaughter. Some 8.5 million Iraqis answered his warning with defiance and determination, just as millions of Afghans defied al Qaeda and the Taliban last October.

Beyond the numbers of terrorists who have been killed or captured, or who live their lives on the run, something equally as important has happened.

In just the last three years alone, in regions some previously judged immune to the democratic spirit, there has been an extraordinary movement toward representative government—what President Bush has rightly called the ultimate weapon against the terrorists' bleak vision of death and despair.

Thanks in no small part to the efforts and sacrifices of American men and women in uniform, some 50 million people in Afghanistan and Iraq—most of them Muslims—are now themselves helping advance the cause of freedom in the Muslim world.

But, Afghans and Iraqis are not alone.

There seems to be a larger movement of the democratic spirit at work, and it has been due, in great measure, to the courage and commitment of brave and committed citizens themselves—in many cases, without the involvement of U.S. military force.

- Last September, for example, democracy triumphed in circumstances less dramatic perhaps than those in Afghanistan and Iraq, but no less important. Indonesia, the country with the largest Muslim population in the world, held its second successive free and fair election of a president, a milestone often considered a landmark on the road to democracy

- In January, the Palestinian Authority held an historic election that has produced new leadership that may finally deliver for the Palestinian people the state they have long deserved.

- In Lebanon, tens of thousands of people have come out to demonstrate in the wake of the assassination of former Prime Minister Rafiq Hariri. Despite clear risks to their safety, Lebanese people wanted to show their commitment to freedom for their country. As we saw just yesterday, the Syrian-backed government in Lebanon resigned under popular pressure.

And, of course, citizens were a powerful driving force for freedom in Afghanistan and in Iraq. In those cases, American soldiers proudly helped facilitate these two important elections—pointing to some of the key results of America's military investment in the region. But the one thing American soldiers couldn't do was vote. And that Afghans and Iraqis did with great courage and in enormous numbers.

While the military is not the only national instrument that has contributed to these important gains, its indispensable role is unquestionably the most expensive—in terms of

the resources it demands of the American taxpayer, and especially in terms of the sacrifices it demands of our men and women in uniform, including those who have made the ultimate sacrifice for our freedom and security.

Americans have wholeheartedly supported their military men and women who serve on the frontlines and at home to ensure they have the tools, the training, and the care they need. This Defense budget is primarily about them, about their future and ours as Americans.

It is in this context that the President has requested $419.3 billion in discretionary budget authority for Department of Defense (DoD), a 4.8 percent increase from FY 2005. Combined with the supplemental, this request includes sufficient funding to sustain the President's pledges to defeat global terrorism, restructure America's armed forces and global defense posture, develop and field advanced war fighting capabilities, and provide for the needs of our forces.

The President's request reflects the decisions of DoD's senior civilian and military leaders as to how we can best meet current and future requirements. The President provided the Defense Department with a topline that steadily increases through FY 2011, reflecting what we believe to be the best plan for countering global security threats and developing and fielding capabilities to meet future dangers.

**FY 2005 Supplemental Request**

Before I discuss the 2006 budget request, I'd like to begin with a few words about the supplemental. The President has pledged that our troops will have what they need to fight and win this war on terror. The President's recent request for an additional $74.9 billion in FY 2005 DoD supplemental appropriations—on top of the $25 billion appropriations approved last August—keeps that solemn pledge. Rapid and full approval of the supplemental request is crucial to the Department's ability to meet our military requirements for the rest of this fiscal year.

Of critical importance, this supplemental provides significant resources to address wear and tear on our military equipment, to create a larger, more combat capable Army and Marine Corps, and to train and equip Iraqi and Afghan security forces to empower them to take the fight to the extremists and to help them take control of their future. I will briefly address each of these three topics.

**Resetting the force.** A high operating tempo is causing significant wear and tear on some of our war fighting equipment. The supplemental includes $11.9 billion to reset or recapitalize the force, which is essential to ensuring military readiness. We have asked for $3.2 billion for depot maintenance, $5.4 billion to replace military items destroyed or expended during combat operations, and $3.3 billion to improve protection of our forces.

Our commitment is to keep military units at full combat strength and provide them with the equipment they need to be ready when we need them.

**Restructuring ground forces.** The Department has made a major commitment to restructuring the Army—adding $35 billion over 7 years (FY2005-2011) to the $13 billion in the Army baseline budget.

Restructuring will increase the number of Army brigades and convert them into brigade combat teams (BCTs) that are capable of independent operations. Let me take a moment here to explain in a bit more detail what we mean when we talk about that conversion, what the Army terms "Army modularity"—a somewhat obscure phrase that belies its exciting implications.

In truth, what the Army is undertaking is a remarkable and fundamental transformation in the way it organizes and thinks about deploying forces.

The Department has made a major commitment to this type of restructuring for its ground forces, which is designed to do nothing short of adding more deployable units, creating a larger rotational base and increasing flexibility—thus relieving the strain on the Total Force by creating more deployable units.

The Active Army, for example, will expand from 33 maneuver brigades in FY 2003 to 43 BCTs in FY 2007. The current Army plan is to restructure the Army National Guard to reach 34 trained and ready BCTs by FY 2010. The most significant consequence of this expansion is that for any required level of overseas force deployment, active brigades will deploy less often and reserve maneuver brigades will be called up much less frequently.

The Army's 3rd Infantry Division, for example, is the first to complete the transformation, going from three brigades into four independently deployable units. The division has just deployed to Iraq for the second time, where it is putting this new concept into practice. The 3rd ID relieved the 1st Cavalry Division, which will implement the same transformation when it returns to Fort Hood.

The recent history of the 3rd ID helps explain why we are funding the Army's transformation in FY05 and FY06 from supplemental funds. As the 3rd ID redeployed from Iraq some 15 months ago, we simultaneously reset it from the wear and tear of combat, and transformed it from three brigades to four.

In FY 2005 and FY 2006, the Department proposes to fund Army restructuring through supplemental appropriations because acceleration of this effort is urgent and vital to the war on terror. The funds requested in supplementals will accelerate the restructuring of ground forces moving into theater and reset those forces rotating out of theater.

Thus, supplemental funding is critical because it addresses two urgent

requirements. First, it rapidly expands the operating size and combat power of the Army—making our forces more effective in the global war on terror and making their deployment more sustainable. Second, by creating a larger number of more capable brigades available for rotation, it significantly reduces the strain on our military units and troops. Beginning in FY 2007, we will request funding for restructuring in the baseline Army budget. By '07, we expect both the rotational strain on our troops to be less and our understanding of the costs of transformation to be more exact.

The Marine Corps is restructuring to add two active infantry battalions and other combat and support units—increasing its warfighting power and reducing stress on capabilities that are in high demand.

**Train & equip.** The supplemental also funds the vital strategic goal of training and equipping indigenous military and security forces in Iraq and Afghanistan. Building the capabilities of these countries' forces is essential to the long-term security and stability in both nations, and will enable them to become more self-sufficient and less reliant on U.S and coalition forces. I urge full funding of our request and creation of an Iraq Security Forces Fund and Afghanistan Security Forces Fund to provide the resources we need to train these forces so that they may take control of their own security needs.

Members of Iraq's security forces were willing participants in January's choice for freedom, and several bravely gave their lives to shield Iraqi voters from suicide bombers and insurgents. Their performance on the January 30 election day is visible and tangible evidence of the returns we are getting from our substantial investment in Iraqi security forces.

In a recent call with General Casey, he told us that, since the elections, Iraqi security forces have grown much more confident. As General Myers reported last week in his testimony before members of the House Appropriations Committee, on February $14^{th}$, some 8,000 to 10,000 men arrived at an airfield outside an Iraqi army base, hoping to join the army. And, as General Casey also told us, the Iraqi people have become more confident of an army made up Iraqi patriots who are their husbands, their daughters and their sons—some 1,400 police, soldiers and government officials who have died since Iraq's liberation. And millions of Iraqis can proudly claim themselves to have braved the terrorists' threats in order to take Iraq's future into their own hands.

**Tsunami relief.** The supplemental also requests funds to address recovery efforts in the wake of the December tsunami in Southeast Asia. We have an enormous stake in making sure that subsequent efforts build on the success we have already achieved. The President's request includes funding to rebuild vital infrastructure critical to strengthening economies and societies, especially in Indonesia's Aceh province, the area hardest hit.

The benefits of this assistance promise to extend far beyond Indonesia, especially as this emerging democracy seeks to join the community of free nations. A recent poll indicates that there has been a positive change in public opinion in the region, after people saw how Americans, especially service members, labored to bring them life-saving water, food and other supplies—ultimately helping avoid a larger humanitarian tragedy. I saw the efforts of the young sailors from the USS Lincoln, as did members of Congress. They were eager and enthusiastic volunteers, whose tireless and selfless efforts were truly inspiring.

We now have the opportunity—unfortunately born of terrible tragedy—to build on their wonderful work by helping Indonesia strengthen its democratic institutions as we help it rebuild its vital infrastructure. It is certainly in our interests to do so: If Indonesia, a country of almost 240 million people, with more than 15 percent of the world's Muslims, can demonstrate its capacity to develop democratic institutions, it will become the world's third largest democracy and, along with Turkey, it will be another example of success in the Muslim world—to be joined by Afghanistan and Iraq and hopefully others.

Such significant moves towards representative government in the Muslim world would be well worth America's investment.

**Supporting the War on Terror: Balancing Difficult Choices and Making Smart Choices for the Future**

Looking beyond the supplemental, the proposed FY 2006 budget is sizable, by historical standards, but it is a sustainable defense burden, especially compared to previous war-time periods. Americans may be assured, however, that we are balancing this budget request with some difficult choices among competing needs. Now we need Congress's support of those tough choices.

To get the most out of America's investment in defense, the budget reflects continuing work to restructure U.S. forces and our global defense posture and stateside basing—what we believe are smart choices designed to achieve more combat power without a commensurate increase in troops or funding.

Beyond concepts like Army modularity, something equally remarkable is taking place in the way in which we base our forces. We are changing fundamentally the character of our global stationing and, at the same time, we are going through a major effort to realign our basing posture to ensure that our basing structure here in the United States supports the essentially expeditionary character of most of our forces. This will also support the new requirements for homeland defense.

We are focusing on two key initiatives regarding global and stateside basing to ensure that U.S. forces and equipment are located where they can best respond to likely requirements of the security environment of the 21st century. The President's global posture restructuring will return 70,000 military personnel and 100,000 family members

to the United States, and relocate forces and equipment that will remain overseas. The 2005 Base and Realignment and Closure (BRAC) Commission will take this return from overseas into account when deciding how best to streamline and restructure the Department's installations here in the United States.

Along with these restructuring efforts, each of the military services is continuing to pursue key initiatives to manage more effectively the current demand on U.S. forces. Rebalancing forces in both Active and Reserve, for example, will give us an increase in high-demand units and personnel skills and a reduction in certain low demand units and skills. Military-to-civilian conversions are expanding the rotational base for military deployments and the support base for other core defense functions.

**New Capabilities**

The FY 2006 budget funds a balanced combination of programs to develop and field the capabilities most needed by America's military. It continues to focus more intensely on the most promising technologies. It continues to strengthen U.S. missile defenses. It accelerates the fielding of new networking technologies and other capabilities to make the new modular Army even more powerful. It continues the Navy and Marine Corps shift to a new generation of ships and related capabilities. It continues the acquisition of Air Force, Navy and other aircraft to sustain U.S. air dominance and provide strong airlift and logistics support to joint forces. And it advances development of new intelligence and communications capabilities with many times the capacity of existing systems.

Most importantly, the budget provides for our most valuable asset—our people—by maintaining the President's commitment to take care of our military men and women and their families. It includes a 3.1 percent increase in military base pay. It also includes an increase in funding to ensure continuing good health care, and it sustains our commitment to no average out-of-pocket costs for military members living in private housing. The budget also keeps the Defense Department on track to fully fund by FY 2007 the elimination of all inadequate military family housing units in the U.S., and to fund by FY 2009 the elimination of all inadequate units worldwide.

**Gains in the War on Terror: Return on America's Investment**

American soldiers, sailors, airmen, Marines and Coast Guardsmen, as well their civilian colleagues serving in the global war on terror, have performed magnificently. They have done everything that has been asked of them and more. As of February 28th, more than 1,600 Americans have given their lives in Afghanistan and Iraq and thousands more have been wounded to protect our freedom and encourage liberty's advance for people once enslaved by brutal tyranny.

The men and women of America's armed forces could not have pursued this

noble cause without the strong support of Congress. On behalf of the brave Americans who do serve and have served us so well, I'd like to thank the members of this Committee and the entire Congress for their continued bipartisan support.

Of course, because of all these efforts, we can point to some truly significant gains on the many and varied fronts in the global war on terror, some of which I mentioned earlier. But, we must not allow ourselves to become complacent just because this country has not been attacked in the last three years. We know that the terrorists are still actively plotting to do so, and we must maintain strong pressure on them and, if possible, intensify it.

As General Myers noted last week, U.S. forces got very close to Abu Musab al-Zarqawi, the al Qaeda terrorist who has been attacking and killing Iraqis to try to start a civil war. Life for him these days is lived on the run, in one secret hideout after another—especially as his lieutenants and trusted followers continue to be captured. In the regions that straddle the Pakistan-Afghan border, Pakistani armed forces, supported by active American operations on the Afghan side of the border, are putting intense pressure on al Qaeda leadership hiding in Northwest Pakistan.

Although capturing and killing terrorists is critically important, this struggle is not just about those activities alone. As President Bush said in his Inaugural Address, "The best hope for peace in our world is the expansion of freedom in all the world." That means reaching out to mainstream Muslims who want freedom and democracy and prosperity.

Terrorists fear this bold course, which is why they fight to impose on their fellow Muslims a medieval, intolerant, tyrannical way of life.

It is this fear that prompted members of the Taliban to issue threats against Afghan voters. In Iraq, It is the fear of freedom and self-determination that also caused Osama bin Laden to declare war on the Iraqi people, calling them "apostates." Zarqawi said they'd declared war on the evil principle of democracy, because it is based on the right to choose one's religion, a concept he declared was "against the rule of God."

As we know, despite these threats, the Iraqi people exercised their newfound freedom and voted anyway. The story of Iraq's election is a story of enormous courage by 8-1/2 million Iraqis, every one of whom knew they were taking a personal risk to mark their fingers with that vivid purple ink, telling everyone, including the terrorists, exactly where they stood.

With this mass heroism, there were some extraordinary feats of individual heroism, including two Iraqi policemen who knowingly sacrificed their lives to tackle and stop suicide bombers who then blew themselves up. Two of the stories that have impressed me the most came from Arab neighborhoods in Mosul, one of the most intimidated areas in northern Iraq.

The first was told to me by Brigadier General Carter Ham, the commander of coalition forces in Mosul. In one polling station in a Sunni Arab neighborhood, a crowd of several hundred people gathered at a distance to watch. After the station had been open for two hours, still no one had voted. No one, that is, until one old woman said, "I've waited all my life for this opportunity," as she stepped forward. The will to fight for freedom apparently does not diminish with age or infirmity. The rest of the people saw the courage of this elderly patriot, and they too came forward to vote.

The second story took place in another Arab neighborhood in Mosul, where the killers fired at a line of voters, wounding one of them. Instead of dispersing, these voters amazingly stayed in line. They crouched down to present a smaller target, and moved to put themselves between the attackers and the wounded voter while the Iraqi Army evacuated him.

It is difficult to imagine people anywhere in the world showing more courage and determination to vote in the face of intimidation. While our men and women deserve extraordinary gratitude and credit for making this achievement possible, as I am sure they would be the first to acknowledge, the real heroes on Iraq's Election Day were the Iraqi people themselves.

As President Bush observed, by successfully conducting free elections, Iraqi men and women have taken rightful control of their country's destiny. They rejected bin Laden's false claims, and chose for themselves a future of freedom and peace.

As impressive as are January's election and other gains, Iraqis still face a difficult road to defeat the terrorist threat and achieve stability, much less freedom and democracy. But our investment in training Iraqis to defend themselves has begun to pay off. And it will only continue to do so—especially as their growing ascendancy translates into a reduction of stress and strain on American troops—which is one of our key goals.

**Closing**

Our investments in the many fronts of the global war on terror have given us some important returns. But, we must remain resolved and patient going forward, for there is much yet to do. A problem that grew up in 20 or 30 years is not going away in two or three. We may recall how long we waged the Cold War, and how long it took to rebuild Western Europe. In both cases, we know how the story ends. We know that seemingly impossible challenges can be achieved—when leaders are determined to persevere ... and when the American people and their allies are resolved to stand firm for freedom.

Freedom is the glue of the world's strongest alliances and the solvent that has dissolved tyrannical rule. The same values that held the Allies together over the course of four decades of often contentious debates are the values that have brought some 40 countries into the Coalition effort in Afghanistan, more than 30 countries with us into Iraq, and some 80 or 90 countries into the larger coalition against global terrorism. The longing for freedom that penetrated even the Iron Curtain brought about the peaceful end to the Cold War. That same universal desire for liberty—among Muslims as well as non-Muslims—will be our strongest weapon in fighting fanaticism today.

The President's FY 2006 budget addresses our country's need to fight the war on terror, to support our men and women in uniform, and prepare to meet the threats of the 21st Century. It reflects difficult choices to ensure sufficient funding for our most pressing requirements and to advance capabilities that increase our combat power. Those difficult choices and our proposed transformation of the business of defense underscores our resolve to be wise stewards of taxpayer dollars.

This Committee has provided our country strong leadership in providing for the national defense and ensuring taxpayers' dollars are wisely spent. We look forward to continuing our work with you to achieve both of these critical goals.

Chairman GREGG. Thank you, Mr. Secretary.
The meeting is adjourned.
[Whereupon, at 11:47 a.m., the Committee was adjourned.]

## Responses to Questions submitted by Senator Domenici to General Pace for the Record

**Question:** Can you discuss the current strategic approach pursued by the Department to address the persistent rocket, artillery and mortar threat that continues to kill and injure our troops in Iraq?

**Answer:** The Chief of Staff of the Army initiated a Countering Rockets, Artillerly and Motors (C-RAM) effort in May 2004. The Army is aggressively fielding 2 Intergrated Area Defense Intercept systems to 1 Point Defense, Sensing and Warning is based upon successful demonstration late last year. The demonstration system comprised the Ranger's Lightweight Counter Mortar Radar with the Navy Close In Weapons System (CIWS is a 20 mm Phalanx gun system). The DepSecDef requested fielding acceleration options. Those options are in development.

Additionally, a Joint Staff directed, Army led Intergrated Air and Missile Defense Capabilities Assessment (IAMD CBA) currently underway includes C-RAM capabilities. The functional solutions analysis poortion of the IAMD CBA will examine all potential material approaches and provide an evaluation of the operational effectiveness, operational suitability and estimated costs of alternative systems to meet this mission capability.

## Responses to Questions submitted by Senator Nelson to General Pace for the Record

**Question:** Section 153 of Title 10, US Code requires the Chairman of the Joint Chiefs of Staff to submit a "risk assessment" each year. If the Chairman's assessment in any year is that a risk is "significant," the Secretary must include a plan for mitigating that risk. Why has the Chairman's risk assessment not cleared the Pentagon and arrived on the Hill as required?

**Answer:** Title 10 requires the Chairman's annual risk assessment to be submitted through the Secretary of Defense. It was approved by Gen Myers on 4 March and is currently with OSD for development of mitigation options given the characterization of risk. Title 10 requires that the Secretary forward the Chairman's risk assessment and the Secretary's comments/mitigation plan with the Department's budget justification materials, which OSD say will be in late March.

**Question:** Given the pace and scope of operations around the world; the extension, and arguably over-extension of our ground forces as they are currently configured; and the strategic uncertainty of conditions in many areas around the world like the North and Southwest Pacific, do you think it is strategically prudent to reduce our Nation's aircraft carrier capability at this time?

**Answer:** Crisis response and deterrence through global presence are the prinicipal aspects of the carrier fleet's contribution to our national defense strategy. Using innovative joint solutions such as global force management, global posture realignment initiatives and use of rotational expeditionary forces and the Navy Fleet Response Plan, risk associated with the reduction of our Nation's aircraft carrier numbers can be mitigated.

With regard to the North and Southwest Pacific, current global posture realignment initiatives are examining ways to increase our ability to project military forces rapidly, at long ranges, by establishing a network of forward operating sites and cooperative security locations.

Determining the approriate size of the carrier force has long been a topic of debate in force-structure planning. As the strategic environment changes, DOD will continue to assess the force structure necessary to execute the missions of the National Military Strategy.

**Question:** The Navy has based its willingness to cut a carrier—in order to satisfy the Department's late breaking requirement for a budget reduction—on initial results of experimentation with the "Fleet Response Plan." I recall that the Air Force essentially experimented with the Aerospace Expeditionary Force concept for about

two years before deploying it throughout the force. In your judgment, is a single experiment with a new operating approach sufficient to base a reduction of this magnitude in our carrier force?

**Answer:** The Fleet Response Plan (FRP) was designed and implemented prior to the Service determination to reduce the carrier fleet by one. FRP realigns fleet maintenance and training cycles to increase the number of months a group is available and ready to deploy in support of global contingencies. FRP, by design, does not appreciably increase the Navy's capability to provide routine forward deployed global Carrier Strike Group presence; however, the increased availability provided since the implementation of FRP has postured the Navy to rapidly respond to emergent world events with the deployment of up to eight Carrier Strike Groups (CSG). Reducing the carrier fleet by one will have a small incremental impact on the Navy's ability to meet Global Naval Force Presence Policy and will slightly reduce the overall number of carriers available for contingency operations. However, FRP has shown great promise as a more effective way to manage our Naval Forces and will contribute to the mitigation of the risk associated with this carrier force reduction.

**Question:** All Atlantic Fleet nuclear aircraft carriers are currently stationed at one port in Norfolk. In your view, what is the strategic risk associated with vulnerable concentrartion of valuable ships in a single port? Would it be more prudent to have the flexibility to station our nuclear aircraft carriers at other locations on the East Coast? How would this impact stationing and construction decisions in the near-term?

**Answer:** At a national level, it would be prudent to mitigate strategic risk associated with carrier stationing by having the ability to station carriers in multiple locations. The ongoing BRAC process will look specifically at the risks and costs of the current and future carrier basing plans and will develop recommendations on basing locations for all of our strategic assets.

**Question:** At presence there are two nuclear-ready carrier ports on the West Coast, but only one on the East Coast. All of our Atlantic Fleet nuclear carriers are homeported in one place. How does the strategic situation justify two ports on the West Coast and only one on the East Coast?

**Answer:** At a national level, it would be prudent to mitigate strategic risk associated with carrier stationing by having the ability to station carriers in multiple locations. The ongoing BRAC process will look specifically at the risks and costs of the current and future carrier basing plans and will develop recommendations on basing locations for all of our strategic assets.

**Question:** Admiral Clark told the Armed Services Committee recently that the Environmental Impact Statement process and MILCON necessary to make Naval Station Mayport CVN-ready will take up to 6 years. What is your assessment of the strategic risk of having only one carrier port on the East Coast through 2011?

**Answer:** At a national level, it would be prudent to mitigate strategic risk associated with carrier stationing by having the ability to station carriers in multiple locations. The ongoing BRAC process will look specifically at the risks and costs of the current and future carrier basing plans and will develop recommendations on basing locations for all of our strategic assets.

**Question:** General Pace, current Defense Department policy offsets the Survivor Benefit Plan (SBP) benefits purchased by 100 percent disabled retired Service member by DIC payments also due to the survivors of retirees and Service members killed on active duty. My staff and I could find no other purchased benefits program that is allowed to refuse to pay its benefits based on the receipt of another benefit. From my experience as Florida insurance commissioner I can tell you that this would be a breech of contract in the private sector. How do you justify this offset?

**Answer:** The Survivor Benefits Plan (SBP) is currently the law of the land. This is an excellent topic to be discussed with the Congress and with the Executive Branch.

## Responses to Questions submitted by Senator Feingold to Dr. Wolfowitz for the Record

**Question:** The Defense Department had the unfortunate distinction of, once again, doinating the GAO's list of high-risk areas open to waste, fraud, and mismanagement. Of particular concern to me since coming to the Senate in 1993 are the chron-

ic problems with DOD's financial management system. The President's FY06 Budget Request still rates the Pentagon's financial management as poor. We are spending half a trillion dollars a year on defense yet the Department of Defense still cannot submit auditable financial records. Is it still your goal to obtain an opinion on DOD's consolidated financial statements by FY2007? Is that a realistic goal? What are you doing to make sure you meet this goal? What are the top challenges you must overcome to meet your goal? If you intend to revise the FY2007 deadline, please provide details.

**Answer:** We have concluded that an unqualified audit opinion (clean audit opinion) on the DoD's consolidated financial statements is not achievable by FY 2007, unless we spend an extraordinary amount of resources to achieve it through unsustainable methods. Hence, our goal is to create sustainable auditability without incurring extraordinary annual costs. We are making progress toward that goal by aligning our business transformation activities, thus creating more transparent material and financial processes in support of warfighter requirements.

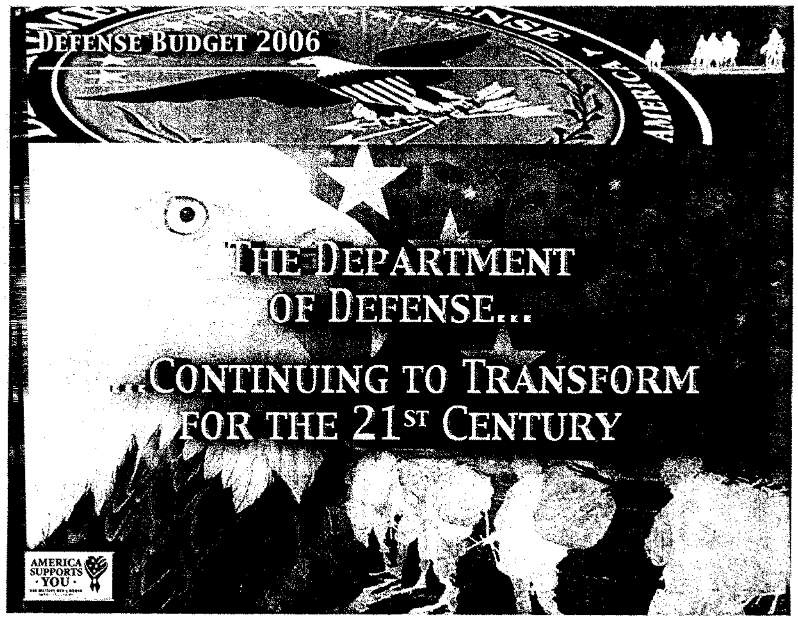
However, the Department continues to make progress toward a clean audit opinion through both improved business processes and business systems modernization. Our progress includes:

Six unqualified and one qualified audit opinion on the Department's subordinate FY2004 financial statements.

BMMP is transitioning from an architecture phase to an implementation phase. Systems efforts are being prioritized to deliver measurable capabilites that will be affirmed by auditable financial statements.

Instituting stronger program governance over the Business Management Modernization Program (BMMP) through the creation of a Defense Business Systems Management Committee chaired by the Deputy Secretary of Defense.

Developing a plan to use the Marine Corps as a test case for achieving an unqualified audit opinion for an entire Service. Our focus on the Marine Corps audit, as an interim deliverable, is intended to help us better understand how to overcome the critical barriers to a clean opinion across the other Services without the duplicative costs that would result from learning those lessons simultaneously. We will use the lessons learned from this to build more predictable audit plans and expectations for the other Services.


DEFENSE BUDGET 2006
THE DEPARTMENT
OF DEFENSE...
...CONTINUING TO TRANSFORM
FOR THE 21ST CENTURY
AMERICA
SUPPORTS
YOU

# Army Modularity

Old:

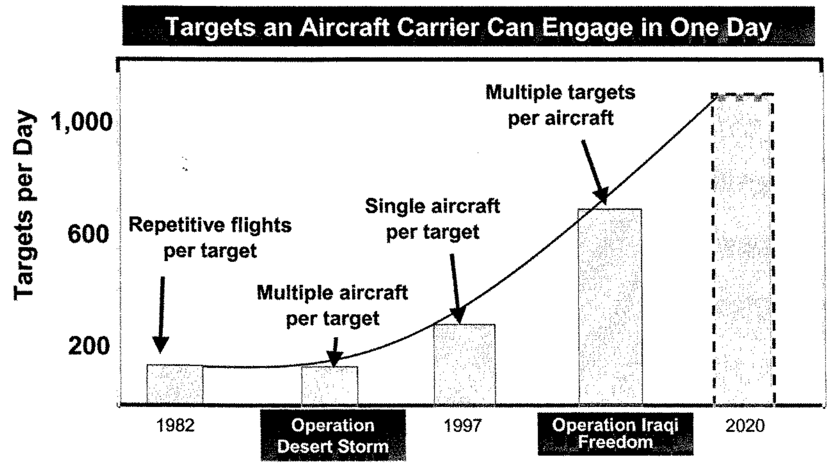
33 Active Brigades $\xrightarrow{\text{supplying}}$ 15, one-year deployments per year $\Longrightarrow$ 1.2 years at home per year deployed

50% increase in time not deployed

New:

43 Active Brigades $\xrightarrow{\text{supplying}}$ 15, one-year deployments per year $\Longrightarrow$ 1.8 years at home per year deployed

# *Transforming Technology*

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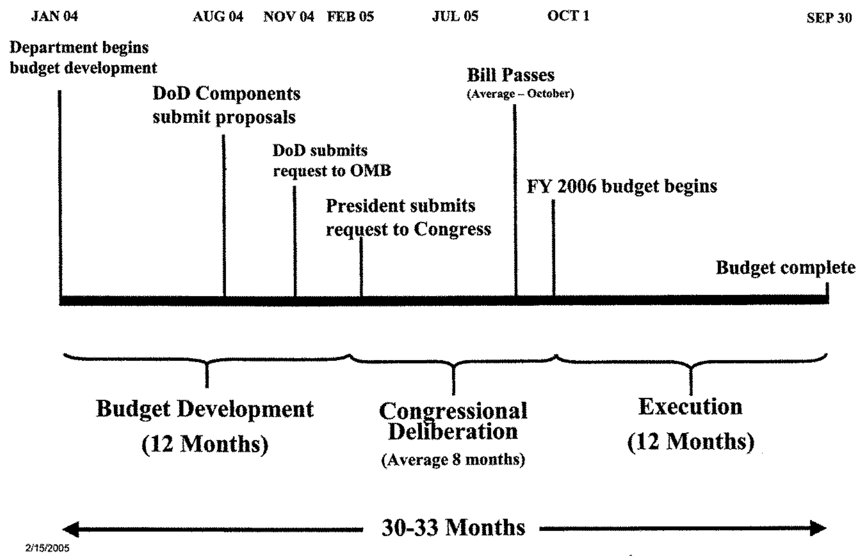
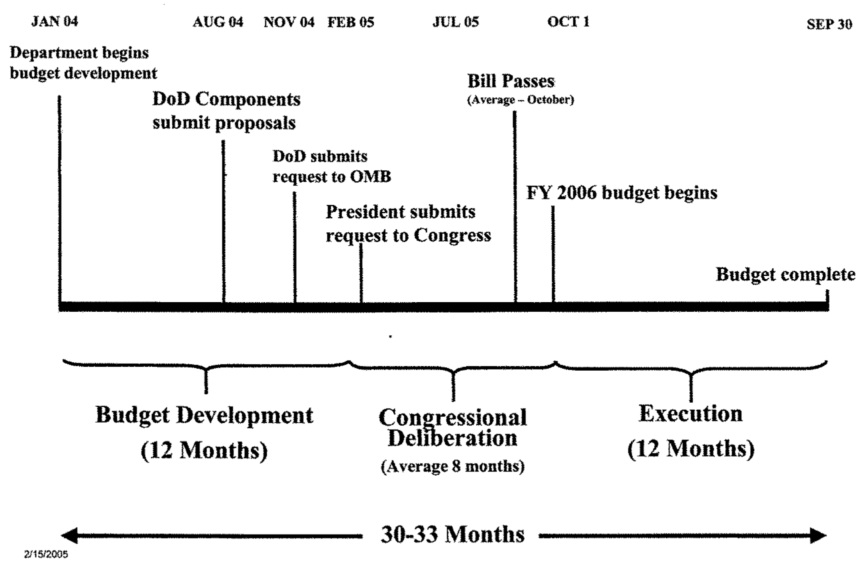
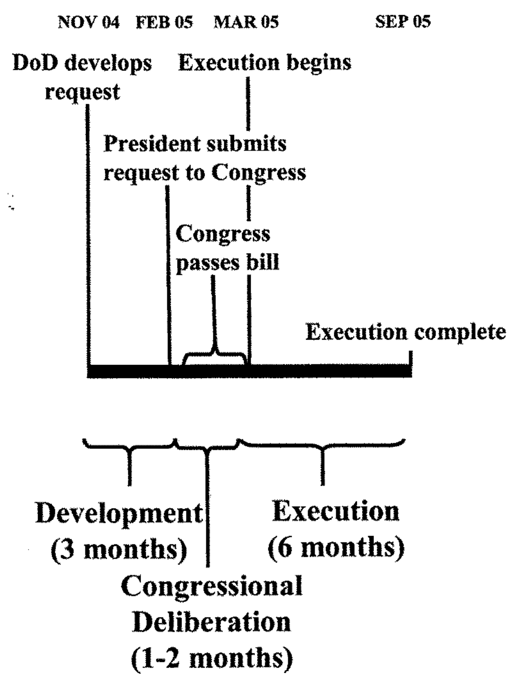
# Baseline FY 06 Budget Cycle



# Baseline FY 06 Budget Cycle



# Supplemental Request Cycle



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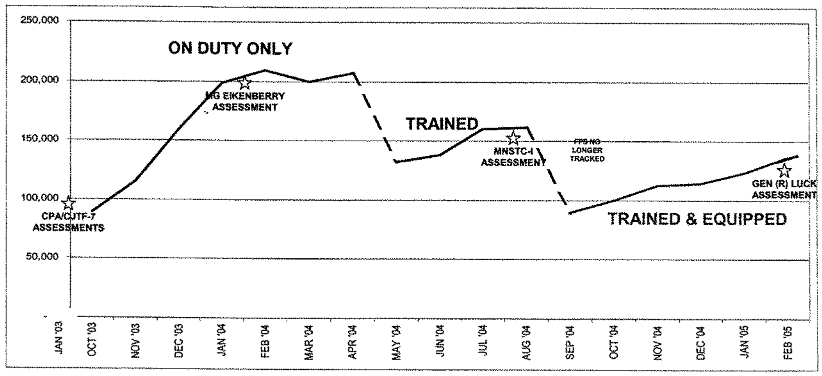
## Historical Perspective on ISF Reporting

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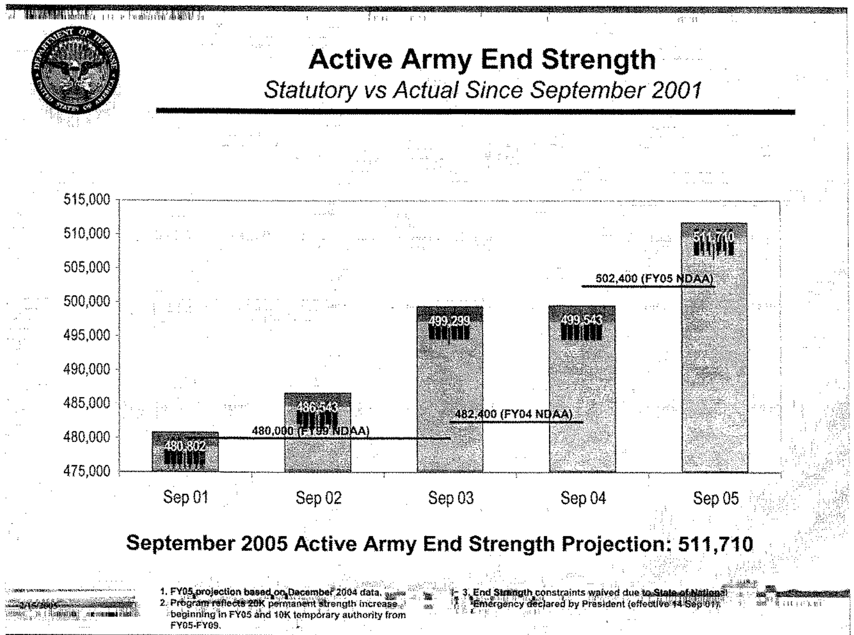
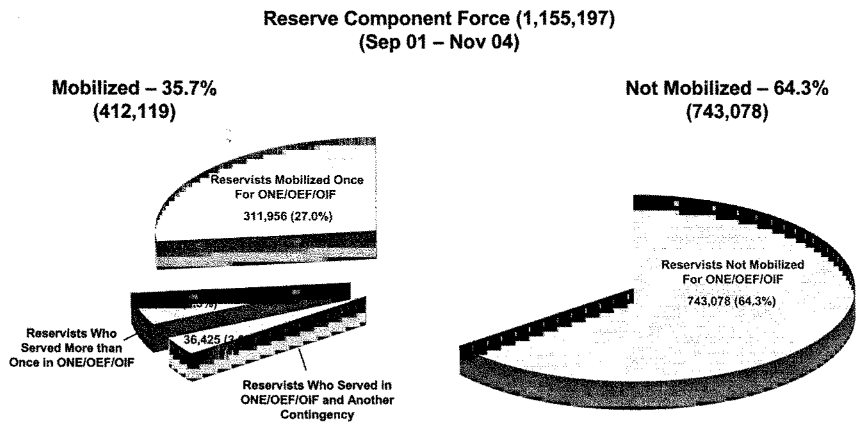

Active Army End Strength
Statutory vs Actual Since September 2001
515,000
510,000
505,000
500,000
495,000
490,000
485,000
480,000
475,000
480,802
486,543
499,299
499,543
511,710
480,000 (FY99 NDAA)
482,400 (FY04 NDAA)
502,400 (FY05 NDAA)
Sep 01
Sep 02
Sep 03
Sep 04
Sep 05
September 2005 Active Army End Strength Projection: 511,710
1. FY05 projection based on December 2004 data.
2. Program reflects 20K permanent strength increase beginning in FY05 and 10K temporary authority from FY05-FY09.
3. End Strength constraints waived due to State of National Emergency declared by President (effective 14 Sep 01).

# Reserve Force Mobilization Statistics

*Cumulative Reserve Component Members Who Served Since 2001 (ONE/OEF/OIF)*



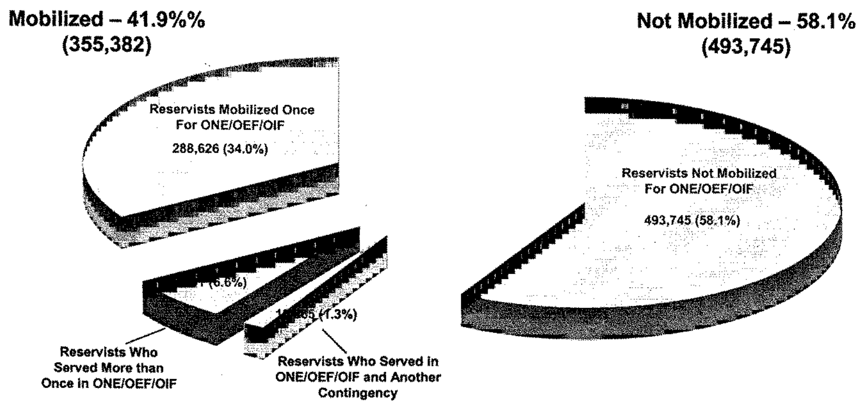

Note: This data reflects individuals mobilized and not mobilized, and is not designed to portray units mobilized and not mobilized.

2/15/2005

# Reserve Force Mobilization Statistics

*Current Reserve Component Members Who Ever Served in ONE/OEF/OIF*

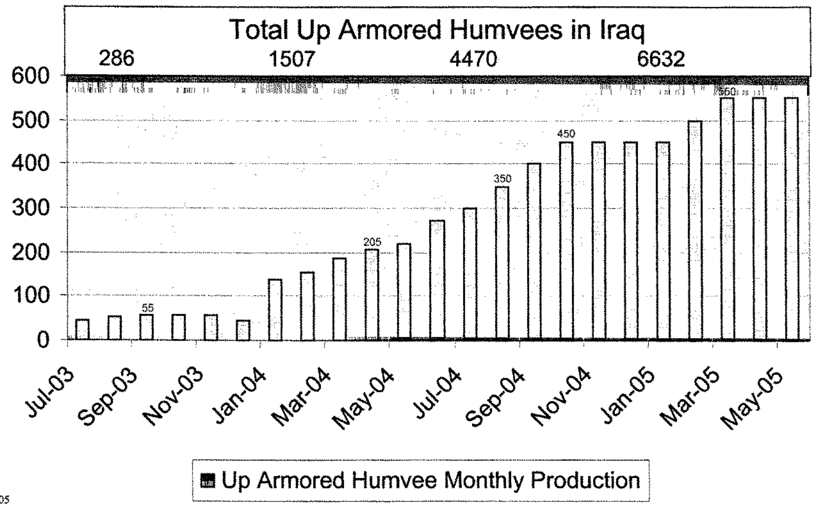
**Reserve Component Force (849,127)**
**(As of: Nov 30, 2004)**




**Note: This data reflects individuals mobilized and not mobilized, and is not designed to portray units mobilized and not mobilized.**

2/15/2005

# Up Armored Humvee Production Rates

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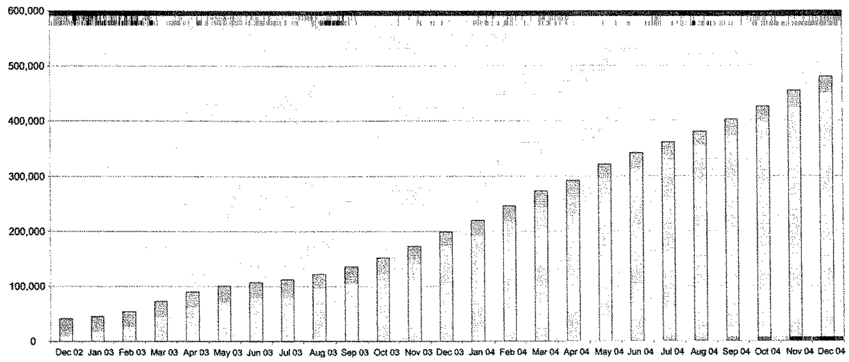
## Small Arms Protective Insert sets - Production Rates

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